Is U.S. Business Overregulated?
How Government Destroys Our Ability to Compete in the Global Economy

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The United States is in a war for competitive survival. While these are harsh words, those readers who fear for or have lost their jobs know that the world takes no prisoners when it comes to economics. There is no mercy if your company is inefficient or lazy or slow to adapt new technology or once enjoyed a dominant market position. The business literature is filled with sad stories of failures to streamline, upgrade, and understand your customer. The American economist Joseph Schumpeter called this “creative destruction,” the idea that competition inevitably forces innovation or the decline of the industry leaders.

Realistically, no book or consultant can fix this situation for companies that are too arrogant or tradition-bound to change. As an advisor over the years to over 250 major corporations and not-for-profits, I have seen many cases of disdain, disinterest, or animosity when suggestions are made for improvements and efficiencies. Often, it is the leading companies in an industry that are the most difficult to motivate, and eventually many of them have had a close call with the business graveyard.

Unreasonable regulation of business – the subject of this book – compounds the problem of company inertia. The United States started its existence as a nation largely opposed to a strong central government but began its movement toward regulatory control as the result of short-term political and economic emergencies. Each crisis inevitably ended, but the controls remained. And given our position of world power, we have exported these ideas to other developed countries, causing the inevitable suboptimal allocation of resources in global markets.

The compliance with business regulation requires the expenditure of billions of dollars that could be spent on innovation and research; on developing new manufacturing processes; and on reducing corporate costs of capital. Conservative business managers simply follow the rules; clever entrepreneurs look for ways to subvert the spirit of the regulation. The government cannot keep up with legal and illegal business activities. A few examples, some of which will be discussed in this book:

- In finance – hedge funds (unregulated so far by the government); unregulated lending by commercial finance companies like GE; unregulated consumer banking services by industrial banks like the proposed Wal-Mart operation or PayPal's consumer finance operation for e-Bay
- In communications – satellite TV operators; satellite radio; pirated DVDs; music downloads without any payment to artists or record companies
- In general business – raising public funds outside the U.S. or going private inside the U.S to avoid Securities and Exchange Commission and Sarbanes-Oxley Act jurisdiction; using political action committees and lobbyists to influence actions by legislators and government regulators; Microsoft's effectively monopolizing its industry and not experiencing a meaningful penalty

It is essential that the U.S. retain its position as a leading free market economy while eliminating artificial barriers to corporate decision-making. The world is not yet flat – to paraphrase Thomas Friedman – but it is changing rapidly and we must respond. To present this argument, an introductory chapter explains the general problem. Part I then examines specific forms of business regulation, including general regulation and selected industry-specific regulation. Part II reviews broader issues relating to the regulatory process, country sovereignty, economics, and globalization.

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CHAPTER 1: INTRODUCTION

Wherever Law ends, Tyranny begins.
John Locke (1632–1704), *Second Treatise of Government*

There is no more critical issue facing America than its ability to compete in the global economy. The loss of manufacturing jobs to countries with five to twenty times lower labor costs may be the most important economic problem of our times. The U.S. has become a service economy that is heavily dependent on the goodwill of two classes of market participants:

- Foreign holders of dollars who keep buying our stocks, bonds, real estate, and other assets
- U.S. consumers whose spending drives some 70 percent of our gross domestic product

America has never developed a comprehensive public policy toward global competition. In fact, the Department of Commerce, the agency charged with the promotion of international business, did not begin to emphasize sales to foreign markets until the 1970s, some 300 years after countries like Great Britain and Holland were actively developing world trade relationships.

If foreign holders of dollars and/or U.S. consumers ever falter in their support for our economy, the result could be a decade-long recession. This is no idle threat; by 2007, housing was in a slump with prices likely to be down for the year for the first time in decades.[1] And in recent years housing "wealth" was what sustained the consumer and supported all those trips to Wal-Mart and to Orlando or Las Vegas. Although there are no quick fixes, the argument of this book is for a new look at our regulation of business to level the playing field against foreign competitors. We may well be our own worst enemy in limiting America's ability to compete in the global economy!

COLONIAL AMERICAN ATTITUDES TOWARD GOVERNMENT

When considering the present, it is important to understand the past. Although history, economics, and political science may have been dry subjects in high school or college, there recently has developed an interest in the events and people that created the American republic. The popular revival of "founding father" history has been encouraged with biographies of such leading figures as George Washington, John Adams, and Benjamin Franklin. A common theme facing the founders was the post-Revolutionary War tension over federalism (centralized government managed primarily by the educated elite), as typified by the policies of Alexander Hamilton; and republicanism (decentralized government with participation by a wide spectrum of Americans), advocated by Thomas Jefferson and James Madison.

The bias of the founders was toward small government: President Washington's administration consisted of a legal counsel and three departments, including State, Treasury, and War. And amazingly enough, only slightly more than 500 employees worked for the new government during peacetime.[2] In contrast, the number of civilian employees of the U.S. government today is nearly two million, equivalent to more than fifty times the growth of the

general population over that period of time.[3]

STRONG VS. WEAK CENTRAL GOVERNMENT

Secretary of the Treasury Hamilton's *Report on Manufactures* advocated that government actively support business,[4] rejecting the republican assumption that America could prosper with an agricultural base. To foster the growth of industry, Hamilton proposed the imposition of protective tariffs and restrictions on imported manufactured goods that would compete with domestic products. Early federal policy supported the development of essential infrastructure for the new country, encouraging banks, canals, and roads and later providing governmental assistance to Western railroads. The modern corporation was promoted through the enactment of laws that limited stockholder liability and conferred new powers to organizers of large enterprises. Great Britain, continental European governments, and Japan similarly accepted responsibility for the encouragement of private enterprise.

Until the period of the Civil War, Americans largely resisted entrusting too much direct power in the hands of a strong central government. The national antagonism toward Great Britain in general and King George III in particular repulsed many Americans, and citizens of the new country assumed that local control of essential public services was adequate to fulfill their requirements for postal delivery, fire and police protection, and similar services. Central government was thought to be needed only for national defense, as in the two early wars with Great Britain (the Revolutionary War and the War of 1812); in matters of international diplomacy, as managed by the Department of State; and in collecting tax revenues from the Customs Service to pay for these activities.[5]

EARLY FORMS OF BUSINESS REGULATION

The American experience after the Revolutionary War generally rejected everything that was British, especially the concept of a “benign” sovereign who would determine the best interests of his or her subjects. Republicanism assumed that citizens could make their own decisions about the conduct of their affairs with minimal interference from the government. This attitude certainly extended to the fledgling business system, which embraced capitalism and free enterprise while rejecting mercantilism and a controlled economy.

BRITISH MERCANTILISM AND REGULATION

“Mercantilism” is often misunderstood today as the successor to feudalism that was based primarily on exports and the holding of a treasury of precious metals. In actuality, the British and Continental versions evolved to this concept only after a lengthy period of localized controls used to further national or collective interests rather than individual wealth. Profit and competition were discouraged; instead, regulation through guild controls[6] sought to maintain prices so that the maximum number of citizens could be provided for reasonably by the economic system.[7]

Business regulation in Western society therefore began at the town level through restrictions over production and prices. The British guilds determined terms and conditions of membership within most industries, focusing on business conducted within each local area. Commerce eventually migrated to the countryside to escape this regimentation and the accompanying taxation on members, with the result that the national government was forced to rely on exclusive trade privileges – monopolies – to generate the revenue required to pursue such political goals as religious and commercial military campaigns. A

major issue over the seventeenth and eighteenth centuries became the licensing and management of these monopolies, a dilemma that would come to America by the end of the nineteenth century.

REGULATION BY TARIFF

In the U.S., the regulation of business effectively began during the administration of George Washington when Congress approved the recommendations in Hamilton’s report on the promotion of American business activity as a coherent federal policy.[8] Tariffs were thought necessary to provide funds for the national government, particularly as there was no other significant source of the revenue needed to provide for domestic programs and to develop a military. Hamilton also intended to protect infant American industry as it struggled to compete with the mature industrial nations of Europe. However, the concept of a tariff or any other barrier to free trade gives economic power to an appointed or elected authority (the Customs Service in this case) to make decisions that more efficiently would be made by free market forces. For more on tariffs and other trade restrictions, see Figure 1-1.

Figure 1-1:
A Note on the Impact of Tariffs and Quotas on International Trade

International trade was historically impacted by the presence of tariff and quota systems established by nations against the free importation of foreign goods. A tariff is effectively a tax levied by a customs bureau and is based on the country of origin, the nature of the goods, and the value of the imports. A quota is a limitation on the quantity of goods that can be imported and is established either on all items of a particular class or by exporting country. There are some reasonable justifications for both systems, including the protection of infant and developing industries that would otherwise be overwhelmed by mature manufacturers; protection of products that are essential to the national defense; and retaliation against countries that are thought to be unfairly restricting trade.

International cooperation toward tariff reductions and such other barriers as quotas began after World War II. Nearly two dozen countries initiated discussions through the General Agreement on Tariffs and Trade (GATT), negotiating in Geneva, Switzerland. Subsequent "rounds" through the late 1940s and ending in the mid-1990s resulted in a reduction in average tariffs from 40 percent to 5 percent, allowing the volume of international trade to increase by twenty times. However, nontariff barriers continued to be serious impediments to trade, and services – not covered by GATT – were becoming increasingly important, affecting about one-quarter of total global business activities. As the result, a new body was created in 1995 – the World Trade Organization (WTO) – to continue the movement toward free trade and to settle disputes among member countries.

One of the remaining international trade disputes involves subsidies for agricultural products. Developing countries have long insisted that they cannot compete with developed economies that provide price supports or guarantees to their farmers. In late 2005 the WTO was able to negotiate the ending of subsidies for agricultural exports by 2013.* However, there is still no agreement on domestically grown and consumed farm products. In addition, tariffs continue to be assessed on manufactured goods, although the WTO has a long-term goal of eliminating these charges entirely.

The impact of these developments has been to greatly increase competition between companies in nearly every part of the world. The insulation of U.S. industry by trade barrier has effectively ended, and American companies are competing with businesses in both developed economy and developing economy countries. Antitrust effectively assumes that U.S. business experiences minimal international competition; nothing could be further from the truth.

**** Keith Bradsher, "Trade Officials Agree to End Subsidies for Agricultural Exports," New York Times, December 19, 2005, C1-C2.***

A tariff is an indirect form of business regulation, because it artificially raises the final price of goods and services to buyers. For example, machinery imported from Great Britain might face a tariff of 20 percent, effectively increasing its price in the U.S. marketplace by that amount. If comparable machinery is available from local producers, any buyer would have to seriously consider the less expensive domestic alternative. Conversely, tariffs usually result in equivalent responses from other nations, making it more expensive for foreign buyers to acquire American goods. Thus, the tariff "regulates" commerce by reducing exporting opportunities for producers and increasing sales of domestic companies.

This became a very real issue in the 1830s, with Northern industrial companies profiting from the restriction on foreign competition and Southern planters unable to sell their cotton in international markets. South Carolina was particularly agitated about the tariff issue, and using the device of a special convention (rather than the legislature or an executive proclamation) issued an Ordinance of Nullification in late 1832. The purpose of this document was to declare the federal tariffs of 1828 and 1832 unconstitutional and void in the state effective in February, 1833. An angry response by President Andrew Jackson, including the threat of military invasion, ended the crisis.[9]

CURRENT TRADE BARRIER EXPERIENCE

In addition to disrupting the action of a market economy, protectionist tariffs do not end when the "infant industries" have matured to adulthood. Just prior to World War I, American tariffs were averaging 44 percent (on manufactured goods as a percent of their value),[10] reflecting the continuing desire to raise revenues and to favor U.S. industry. It has only been since the General Agreement on Trade and Tariffs (GATT), begun after World War II, and its successor, the World Trade Organization (WTO), that nations have made serious efforts at reducing and eliminating tariff protection.[11] GATT's eight rounds of trade negotiations resulted in average tariff reductions of 35 percent, and the amount of the tariff was down to 3.9 percent by 2000.[12]

Continuing disputes among the member nations of the WTO and anti-globalization protests have hampered additional free trade initiatives. Future focus will be on agricultural products, where tariffs still remain high as developed countries protect their own farming industries. Agricultural tariff rates are still around 40 percent, and rich nations spend some $300 billion a year in subsidies to support farming.[13] However, progress was made in 2005 on eliminating protections on agricultural exports by 2013.[14]

Restrictions on trade in other forms have existed for centuries, including limitations on foreign direct investment (FDI), quotas, and administrative procedures.

- Limitations on FDI restrict the flow of foreign capital into a country to make it difficult for international companies to establish facilities.

- Quotas are limitations on the quantity of items that can be imported into a country.
- Administrative procedures discriminate against imported goods or services by imposing unreasonable requirements at the point of entry, usually to protect a domestic industry.

Many countries have been progressively removing these restrictions to encourage global business. For example, in the last decade of the twentieth century, 95 percent of all laws concerning FDI created a more favorable environment, according to UN statistics.[15]

THE NEED FOR FEDERAL REGULATION

The first significant national laws that provided specific business regulation did not appear until the period of the Civil War. Banking regulation – the National Currency Act of 1863 and the National Bank Act of 1864 – established a system of government regulation for banks and established the Office of the Comptroller of the Currency. The legislation was required to assist in the financing of the Civil War and to standardize a system of federally supervised national banks. No longer could each state permit its banks to issue currency, a practice that resulted in confusion for both businesses and travelers who had to determine if specific currency had real value in terms of specie (gold and silver).

The Reconstruction period following the war began a period of industrialization that was to continue until nearly the end of the twentieth century. However, at the time of the passage of the first laws regulating business (other than banking), the U.S. was largely agrarian and continued to prefer the republican model. Nearly two-thirds of the population lived in rural America and over 40 percent of all employment was still based on farming.[16] A point often forgotten by modern commentators is that the first business regulation was primarily a response to the demands of farmers and small businesses – those groups that historically rejected big government – who sought relief from the rates charged by railroads to carry their products to market.

QUESTIONING THE ROLE OF BIG BUSINESS

Politicians and writers began debating the role of big business within a decade of the end of the Civil War, with particular focus on the economic and political power of large corporations. The economic environment allowed the development of corporate mechanisms that resulted in the restraint of trade, which were considered to be artificial and unhealthy limitations on the forces of supply and demand in a competitive economy. *Restraint of trade* usually involves actions by a business or a group of businesses acting in collusion to restrict competition. Federal law requires these actions to involve interstate commerce;[17] most states also support competition in business through laws that mirror federal legislation.[18]

Restraint of trade was often managed through trusts that operated as cartels to set prices and quantities of product offered for sale. A trust is an arrangement by which stockholders in several companies transfer their shares to a single set of trustees. In exchange, the stockholders receive a certificate entitling them to a specified share of the consolidated earnings of the jointly managed companies. A cartel is similar in structure, although cartel members typically retain share ownership in their own names and cooperate to set prices and quantities of product offered for sale. The leading example of a cartel today is OPEC, the Organization of Petroleum Exporting Countries. By the 1880s, trusts developed in several industries, including rail transportation, petroleum,

sugar, and steel.

THE TRUSTS AND BUSINESS REGULATION

Angered by the “concentrated capital”[19] of the trusts, the third-party Populist political movement developed in America toward the end of the nineteenth century. Populist reformers felt that business domination of the political process through large contributions to friendly officeholders and effective lobbying in Congress and the state legislatures had reached the point that the practice had begun to undermine the concept of democracy. Demand for a legislative solution led to the passage of two landmark congressional acts to control business:

- The Interstate Commerce Commission Act of 1887, which initially regulated rail transportation and was applied later to the trucking industry
- The Sherman Antitrust Act of 1890, which extended the concept of governmental regulation to any company engaged in interstate business[20]

The essence of the Interstate Commerce Commission Act and the Sherman Act was governmental protection of competition. In debating Senator Sherman’s bill, Congress did not concern itself with economic efficiency or actual harm to consumers. Instead, the legislators responded to a widespread hostility toward business concentration and the resulting potential for governmental corruption and injury to individuals.[21]

These legislative responses were a sort of lynch mob response to some very bad behavior by businessmen wearing black hats. Specific incidents included tripling or quadrupling the price of everything controlled by a trust: the rail rates to farmers trying to get their produce to market; the cost of steel; even the price of sugar.[22] In the "high noon" days of the American frontier, the sheriff would have deputized a posse, rounded up and jailed the villains, and cleaned up the town. Business regulation attempted to placate the citizens of a frontier America and got a real sheriff when President Theodore Roosevelt used the 1890 law to "pistol whip" the trusts.[23]

WHAT IS BUSINESS REGULATION?

Business regulation is generally considered to be those laws and administrative procedures that are intended to protect competition and maximize consumer welfare.[24] Regulation is used to control the behavior of companies when a market economy may lead to results that are suboptimal to the public good. In certain situations, regulation is unquestionably useful, particularly when injury may occur to parties too weak and too scattered to protect themselves. Those parties may be persons, and we safeguard individuals through consumer protection and other laws; see Figure 1-2.

Figure 1-2:
Consumer Protection Laws

Legislation	Purpose
Pure Food and Drug Act (1906)	Protects against the adulteration and misbranding of foods and drugs sold in interstate commerce.

Legislation	Purpose
Food, Drug, and Cosmetic Act (1938)	Protects against the adulteration and sale of foods, drugs, cosmetics, or therapeutic devices and allows the Food and Drug Administration (FDA) to set minimum standards and guidelines for food products.
Wool Products Labeling Act (1940); Fur Products Labeling Act (1951)	Protect manufacturers, distributors, and consumers from undisclosed substitutes and mixtures in manufactured wool and fur products.
Flammable Fabrics Act (1953)	Prohibits the interstate transportation of dangerously flammable wearing apparel and fabrics.
Automobile Information Disclosure Act (1958)	Requires auto manufacturers to put suggested retail prices on all new passenger vehicles.
Textile Fiber Products Identification Act (1958)	Protects producers and consumers against misbranding and false advertising of fiber content of textile fiber products.
Cigarette Labeling Act (1965)	Requires cigarette manufacturers to label cigarettes as hazardous to health.
Fair Packaging and Labeling Act (1966)	Makes unfair or deceptive packaging or labeling of certain consumer commodities illegal.
Child Protection Act (1966); Child Protection and Toy Safety Act (1969)	Removes potentially harmful toys from sale and allows the FDA to pull dangerous products from the market; protects children from toys and other products that contain thermal, electrical, or mechanical hazards.
Truth-in-Lending Act (1968)	Requires full disclosure of all finance charges on consumer credit agreements and in advertisements of credit plans.

Legislation	Purpose
Fair Credit Reporting Act (1970)	Requires that consumer credit reports contain only accurate, relevant, and recent information and are confidential unless a proper party requests them for an appropriate reason.
Consumer Product Safety Act (1972)	Creates an independent agency to protect consumers from unreasonable risk of injury arising from consumer products and to set safety standards.
Magnuson-Moss Warranty/ Federal Trade Commission Improvement Act (1975)	Provides for minimum disclosure standards for written consumer product warranties and allows the FTC to prescribe interpretive rules and policy statements regarding unfair or deceptive practices.
Alcohol Labeling Legislation (1988)	Provides for warning labels on liquor saying that women should not drink when pregnant and that alcohol impairs a person's abilities.
Nutrition Labeling and Education Act (1990)	Requires truthful and uniform nutritional labeling on every food the FDA regulates.

Those parties may be inanimate but vital for our long-term existence, and we attempt protection through laws designed to avoid pollution and ecological damage; see Figure 1-3.

Figure 1-3:

Environmental Protection Laws

Legislation	Purpose
National Environmental Policy Act (1969)	Establishes protections for the environment by establishing policy, setting goals, and requiring environmental impact statements for major construction projects.
Clean Air Act (1970)	Regulates air emissions from area, stationary, and mobile sources, and authorizes the Environmental Protection Agency (EPA) to establish National Ambient Air Quality Standards to protect public health and the environment.
Endangered Species Act (1973)	Provides a program for the conservation of threatened and endangered plants and animals and the habitats in which they are found.
Safe Drinking Water Act (1974)	Protects the quality of drinking water by authorizing the EPA to establish safe standards of purity; requires public water systems to comply with health-related standards.
Toxic Substances Control Act (1976)	Assigns to the EPA the ability to track industrial chemicals currently produced or imported into the U.S.; requires the screening of these chemicals and can require reporting, testing, and banning of those that may pose an environmental hazard.
Clean Water Act (1977)	Establishes a structure for regulating discharges of pollutants into U.S. waters; gives the EPA the authority to implement pollution control programs; sets water quality standards for contaminants in surface waters.

Legislation	Purpose
Comprehensive Environmental Response, Compensation, and Liability Act [Superfund] (1980); Superfund Amendments and Reauthorization Act (1986)	Creates a tax on the chemical and petroleum industries and provides federal authority to respond directly to releases or threatened releases of hazardous substances that may endanger public health or the environment.
Oil Pollution Act (1990)	Strengthens the EPA's ability to prevent and respond to catastrophic oil spills; establishes a trust fund to clean up spills when the responsible party is incapable or unwilling to do so.

Efforts at deregulation began in the 1970s; see Figure 1-4 for specific laws. Several formerly regulated industries were allowed to fully compete on rates and service, with the general result of lower prices to consumers.

Figure 1-4:
Partially Deregulated Industries

Legislation	Purpose
Airline Deregulation Act (1978)	Allows airlines to set fares and determine their own route structure.
Motor Carrier Act and Staggers Rail Act (1980)	Permits the trucking and railroad industries to negotiate rates and service.
Riegle-Neal Act (1994; effective 1997)	Allows banks to do business in any state regardless of the state of their original charter.

Legislation	Purpose
Telecommunications Act (1996)	Reduces barriers to competition in long-distance and local telephone, cable, and television.
Gramm-Leach-Bliley Act (1999)	Permits financial services providers (banks, insurance companies, securities firms, finance companies) to enter any related financial business.

The opening of markets led to some disruptions, the leading example of which is the airline industry. The major national airlines were suddenly forced to compete with start-up carriers, and it became apparent that cost structures that were sustainable when competition was controlled by the decree of a federal agency (the Civil Aeronautics Board) could not be continued. As a result, Delta, Northwest Air, United, and others filed for bankruptcy protection, while airlines like Southwest Airlines and JetBlue have flourished.

SMALL STEPS TOWARD DEREGULATION

In spite of selected attempts to remove federal control, regulation remains pervasive and inevitably affects every business. Any listing of governmental regulation will depend on the bias and approach of the author; see Figure 1-5 for such an attempt including business regulations that could be considered in whole or in part for elimination. Some industries like banking and insurance are regulated in virtually all of their activities. We do this to protect bank depositors who have entrusted their savings to their banker and to protect the community from a bank failure that might have a widespread catastrophic impact. Similarly, the failure of an insurance company would have a devastating effect on policyholders.

Figure 1-5:
Categories of Governmental Regulation

(BR = areas of business regulation that should be considered in whole or in part for elimination)

1. Protections for Individuals and Natural Resources
   a. Environmental Quality (air, water, noise pollution)
   b. Nondiscrimination on the Basis of Race, Sex, Age, or National Origin
   c. Product Safety
   d. Food and Drug Purity
   e. Safety of Aircraft Operation
   f. Safety in Places of Employment
   g. Truth in Advertising
   h. Dishonest Consumer Practices
   i. Labor Organizing and Negotiation
   j. Sale of Alcoholic Beverages
   k. Gambling
   l. Land Use
   m. Licensing of Doctors, Lawyers, and Other Professionals

2. Industry-Specific Protections (BR)
   a. Transportation
   b. Communications
   c. Energy
   d. Banking
   e. Insurance
   f. Securities Issuance and Trading

3. Government Corporations
   a. TVA
   b. AMTRAK
   c. U.S. Postal Service
   d. Multi-State compacts (e.g., the Port Authority of New York and New Jersey)

4. Regulations with Broad Economic Impact (BR)
   a. Antitrust
   b. Corporate Governance
   c. Export and Import Controls and Restrictions

Other industries are subject to product safety requirements and perhaps advertising restrictions but few other limitations. To say that a business is "regulated" does not reveal the extent of the regulation. While there are obviously various objectives in any regulatory scheme, the theme is the protection of competition to provide consumers with a range of choices to attain a desired mixture of price, quality, service, and safety. Competition can also provide an incentive for businesses to pursue technological innovation and other efficiencies to maximize profits, regardless of the extent of the competition within a specific industry.

"LET THE COURTS FIGURE IT OUT"

In a common law system,[25] courts function to decide the meaning of a statute passed by the legislature. While this sounds reasonable and perhaps represents a desirable goal of public policy, the regulation of business to prevent injury to other businesses or to competition is not as logical or as simple as the law suggests. In fact, the laws of business regulation are among the least precise statutes ever passed by Congress, in that the language is often either too broad or too complex.

- Overly broad statutory language pervades the Sherman Act, including such vague terms as "competition," "unfair methods of competition," "conspiracy in restraint of trade," and "monopolize." The same complaint can be made for certain other business regulation that we will discuss throughout this book.

- Excessively complex statutory language includes the laws governing the securities industry (e.g., the Securities Acts of 1933 and 1934 and the Investment Company Act of 1940) and the Custom Service's regulations on importing (i.e., the published U.S. tariff schedule extends to several feet of printed volumes).

Why did Congress do this? Any legislature is essentially a political body responding to the wants and demands of constituents and pressure groups. When a public outcry for action occurs, Congress typically holds hearings, passes laws, and hopes for the best. The Sherman Act and other antitrust laws and the recent law regarding corporate governance – the Sarbanes-Oxley Act of 2002 – clearly reflect public opinion but lack specificity as to the intent or meaning of critical words and phrases along with other deficiencies.

WHAT IS COMPETITION?

A market economy allows the unregulated functioning of an economy and may result in any of several competitive structures:

- Pure competition: Many buyers and sellers operate, no one of which is large enough to control prices or the amount of goods supplied to a market. The leading example of pure competition today is certain types of retailing.
- Monopolistic competition: Large numbers of buyers and sellers offer differentiated products, allowing a small element of price discretion.

Examples of this type of competition include pet food and soft drinks.

- Oligopoly: Few sellers with some pricing control participate in the market because there are significant barriers to entry, including huge capital requirements, access to technology and specialized machinery, difficulty in establishing distribution channels, and other factors. Oligopoly is the most frequently observed form of a competitive market structure and can be found in such manufacturing industries as automobiles, aircraft, aluminum, tires and rubber products, and steel.
- Monopoly: A single business (or a group of businesses acting together) controls a market, and buyers have no alternative source of supply. While monopoly is illegal in the U. S., government-regulated monopolies do exist for public utilities, and monopoly power is granted for limited periods to holders of patents and copyrights.

Pure competition may be desirable theoretically, but it is an impractical goal in an industrial society where a company's enormous capital requirements result in limits on the number of possible competitors. As a result, we have always accepted monopolistic competition and oligopoly as natural and essential economic institutions.

THE PUBLIC INTEREST AND MONOPOLY

The situation is complicated by acceptance of monopolistic behavior when it is deemed to be in the public interest. From the nation's beginning, monopoly has been encouraged in certain situations through a variety of legal and economic barriers to market entry and competition:

- Legal barriers include requirements for charters, licenses, and permits; patent protection for inventions and copyright protection for intellectual property; and government-sanctioned monopolies supposedly in the public interest, including public utilities (e.g., gas, electric, and water) and restrictions on airwaves and other communication access.

- Economic barriers involve those situations where existing companies can largely exclude potential competitors, through economies of scale in manufacturing and/or distribution, product differentiation, discounts for quantity purchasing for large customers, and a variety of other devices, all completely legal.

WHO ARE THE REGULATORS?

The government has constructed an enormous web of business regulators functioning through at least a dozen agencies or departments; for a partial list, see Figure 1-6. Certain of these bureaucratic structures are absolutely necessary to allow the functioning of a market economy. For example, U.S. economic history prior to World War I is filled with the chaos of unregulated business cycles, which led to bank failures, corporate bankruptcies, and in 1907 a near collapse of the economic system. We could not function without the Federal Reserve to establish monetary policy; the Internal Revenue Service to collect taxes; and such departments as the U.S. Department of Transportation to construct highways, airports, and similar infrastructure and the State Department to negotiate treaties and agreements to expedite international trade.

Figure 1-6:

Federal Business Regulators (with standard abbreviations)

- Comptroller of the Currency (OCC)
- Department of Agriculture (DOA)
- Department of Commerce
- Department of Justice (DOJ)
- Environmental Protection Agency (EPA)
- Federal Aviation Administration (FAA)
- Federal Communications Commission (FCC)
- Federal Energy Regulatory Commission (FERC)
- Federal Maritime Commission
- Federal Reserve System (the Fed)
- Federal Trade Commission (FTC)
- Securities and Exchange Commission (SEC)

Unfortunately, government bureaucracy is a kind of clumsy "invisible hand,"[26] in that the judgment of market nonparticipants is often substituted for that of business managers and their customers. Using a system of monetary exchange, an economic system transforms complex decision problems into drastically simplified ones. In the absence of a market system, someone has to face complex business problems, such as which goods and services to produce, how much of the gross domestic product should be consumed instead of saved, what sections of the country should specialize in what kinds of economic activity, and whether society should encourage farming or import agricultural commodities from abroad. In a market system responsive to individual consumer demands, no such questions have to be faced when the invisible hand decides.

THE MARKET SYSTEM AND REGULATION

Much of what occurs in the market system rests in the hands of managers – jobs, prices, production, growth, technology, the standard of living, and the economic security of everyone. Consequently, government officials cannot be indifferent to how well business performs its functions. Depression, inflation, or other economic distress can bring down a government.[27] A major function of public officials, therefore, is to see to it that businesses perform their tasks with a minimum of interference.

What do managers need as a condition for performing in a market system? Government has a responsibility to do whatever is necessary to assure sufficient profits to employ citizens and grow the economy in an orderly manner. For example, if business needs tax relief to induce investment, governments consider the request, acknowledging that the tax concessions may indeed be necessary. In these systems such concessions are often granted. Managers do not appear simply as the representatives of a special interest, but as functionaries performing tasks that governments recognize as indispensable.

Any government representative who understands the requirements of his or her position and the responsibilities that market-oriented systems place on managers will grant a hearing. The official does not have to be bribed, duped, or pressured to do so, nor does he or she have to be an uncritical admirer of business. He or she simply understands that public affairs in market-oriented systems are in the hands of government and management that must collaborate toward the public good.

THEME OF THE BOOK

The theme of this book is that there are "positive" regulations, such as those described earlier, and "negative" regulations, where government officials substitute their judgment for that of the market in situations when such substitution is inappropriate and may result in the suboptimal allocation of the factors of production. As noted in Figure 1-4, there are numerous areas of governmental intervention in business that interfere with its normal and necessary activities, including antitrust, corporate governance, and regulations that deal with specific industries.

As previously suggested and as noted in the opening quote to this chapter, society cannot survive without laws to protect individuals and the environment against the corrupt or criminal actions of business. We must protect the public from the current (and future) generations of Andrew Fastows, Martha Stewarts, and Jack Abramoffs,[28] in the same way that earlier generations investigated and prosecuted Charles Ponzi, Ivar Kreuger, and Richard Whitney.[29] However, this book argues that the laws of business regulation must be reasonable and must reflect the changing requirements of the U.S. and not assume that conditions of previous generations are in any respect similar to those of the twenty-first century.

CHAPTER FORMAT

The attempts by Congress to protect competition that began in the late nineteenth century used business regulation to achieve results that a market economy could not accomplish. However, the world has changed completely, and the old solutions may no longer be appropriate. This book discusses several inherent problems with business regulation, using the following sequence:

Part I: The Chronology of Business Regulation. In the first part of the book we critically review important areas of business regulation – by industry and by subject – in their chronological sequence of passage.

- Chapter 2 evaluates antitrust.
- Chapter 3 examines banking.
- Chapter 4 describes financial services.
- Chapter 5 discusses the airline industry.
- Chapter 6 analyzes corporate governance.

The historical and current situations are described, including the motivations and intentions of Congress and the reasons that the regulation either has failed or has serious, perhaps fatal, problems. At the conclusion of each chapter we review what the U.S. should do. In some instances, laws ought to be considered for repeal; in other situations, specific areas of policy need to be reexamined and changed in the context of international practice, decisions that were made for political rather than economic reasons, new technology, or simply obvious or likely program failure.

Part II: The Effects of Business Regulation. The second part of the book discusses the impact of regulation on American business, particularly in the context of the global economy.

- Chapter 7 discusses the development of the "fourth" branch of government, the regulators.
- Chapter 8 examines country sovereignty and the changing role of the nation-state in the global economy.

- Chapter 9 provides economic analysis, examining the costs and benefits provided by business regulation.
- Chapter 10 discusses the real issue addressed in this book: Should we use regulations to control business activity?

ENDNOTES FOR CHAPTER 1

[1] The National Association of Realtors began keeping records on housing prices in 1968, and no decline has ever been recorded. One estimate is that the last decline was during the Great Depression. "Realtors Expect Home Prices to Show First Annual Decline," *New York Times*, April 12, 2007, C10.

[2] Ron Chernow, *Alexander Hamilton*, 339 (2004).

[3] U.S. Department of Labor, Bureau of Labor Statistics, "Federal Government Executive Branch Civilian Employment, Except U.S. Postal Service," March 2005. The relevant population statistics are about 4 million in 1790 (from U.S. Department of Commerce, *Historical Statistics of the United States*, 1989, series A57-72) and about 296 million in 2005.

[4] *Report on the Subject of Manufactures* (Dec. 5, 1791), in Alexander Hamilton: Writings, 647-734 (Joanne B. Freeman, ed.) (2001).

[5] It was not until 1913 that the income tax was authorized by the 16th Amendment to the U.S. Constitution.

[6] Guilds originated in the Middle Ages as associations of skilled craftsmen in a particular craft. Young workers were often apprenticed to a journeyman as assistants and to learn the trade. This system came to America with early settlers; a famous "graduate" of the guild system was Benjamin Franklin, who began as a printer's apprentice.

[7] Much of this section is based on Thomas B. Nachbar, "Monopoly, Mercantilism, and the Politics of Regulation," 91 Virginia Law Review 1313, 1313-22 (2005).

[8] The regulation of commerce may have begun as early as 1571, with the first discussion in the British House of Commons on the subject of royal trade privileges, a form of monopoly granted by the Crown to favored businessmen in specific industries. For review of the beginnings of British regulation, see Nachbar, ibid., 1327-28 (2005). The first business regulation judicial decision was the famous Darcy case; Darcy v. Allen, 77 English Reports 1260 (King's Bench). The plaintiff sued the defendant for infringement of a royal patent that granted the exclusive right to make, import, and sell playing cards in England. The court held that the grant was void at common law.

[9] For a detailed discussion of the South Carolina nullification crisis, see Sean Wilentz, The Rise of American Democracy (2005), Chapters 10-12.

[10] "Who Wants to Be a Giant?" The Economist: A Survey of the Multinationals, June 24, 1995, 3-4.

[11] GATT began in 1947 with twenty-three countries that agreed to attempt to collectively reduce tariffs and quotas. Successive rounds of negotiation eventually led to the creation of the WTO in 1995. While tariffs and other issues continue to be discussed and negotiated at WTO meetings, there has been significant progress toward the elimination of these restrictions on free trade.

[12] John H. Jackson, The World Trading System 74 (2nd ed., 1997).

[13] "Playing Games with Prosperity," The Economist, July 28, 2001, 25-27.

[14] Keith Bradsher, "Trade Officials Agree to End Subsidies for Agricultural Exports," New York Times, December 19, 2005, C1.

[15] World Investment Report, 2001, United Nations, 2001.

[16] U.S. Department of Commerce, Historical Statistics of the United States, 1989. Population data are from series A57-72; employment data are from series D11-25.

[17] U.S. Constitution, Article I, Section 8: "To regulate Commerce with foreign Nations, and among the several States" [the Commerce Clause].

[18] The emphasis of this book is on federal regulation. Many states have enacted legislation that parallels federal laws; for an overview, see Paul E. Teske, Regulation in the States (2004).

[19] This phrase is attributed to the economist Henry George, in Progress and Poverty: An Inquiry into the Cause of Industrial Depressions and of Increase of Want with Increase of Wealth: The Remedy (1879), Book III, Chapter 4, 9.

[20] The Sherman Act is codified in Title 15 of the United States Code (U.S.C.); see the discussion in Chapter 2. A useful historical review of the Sherman Act is in David Millon, "The Sherman Act and the Balance of Power," 61 Southern California Law Review 1219 (1988).

[21] For extracts from the Sherman Act debates, see Earl W. Kinter, ed., Legislative History of the Federal Antitrust Laws and Related Statutes (1978).

[22] For a history of these situations, see William Letwin, Law and Economic Policy in America: The Evolution of the Sherman Antitrust Act (1981).

[23] See, for example, Edmund Morris, Theodore Rex (2001), particularly the Prologue and Chapter 28.

[24] This concept has been reiterated in numerous Supreme Court decisions; e.g., "the

unrestrained interaction of competitive forces will yield the best allocation of our economic resources … the policy unequivocally laid down by the Act [the Sherman Act] is competition." N. Pac. Ry. Co. v. U.S., 356 U.S. 1, 4 (1958). See also U.S. v. Citizens & So. Nat'l Bank, 422 U.S. 86 (1975); Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979); and Nat'l Collegiate Athletic Ass'n. v. Bd. Of Regents of the Univ. of Okla., 468 U.S. 85, 107 (1984).

[25] A "common law" system is primarily based on judicial interpretation of statutes enacted by a legislature, with precedents used to analyze a specific situation in a trial. However, courts can reinterpret statutes as social policy or other considerations change; e.g., the Plessy v. Ferguson decision 163 U.S. 537 (1896), upholding separate but equal public facilities for different racial groups, was overturned in Brown v. Board of Education of Topeka, 347 U.S. 483 (1954). The U.S. and Great Britain are the leading common law countries. The other major legal system in Western society is civil law, with statutes providing the core of the law as decided by legislatures. France and many Latin American countries are civil law countries.

[26] To misuse Adam Smith's famous phrase: "[B]y directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it." (Italics added.) The Wealth of Nations, Book IV, Chapter II (1776).

[27] A recent example in the U.S. was the defeat of Jimmy Carter by Ronald Reagan in the 1980 presidential election. During the Carter Administration, short-term interest rates reached 20 percent. Another twentieth-century example was the defeat of Herbert Hoover by Franklin D. Roosevelt in the 1932 election.

[28] Fastow pled guilty in 2004 to various charges relating to his responsibilities as treasurer of Enron. Stewart was convicted on insider trading and served prison time beginning in 2004. Abramoff pled guilty in early 2006 to five criminal felony counts in federal court in a scheme to illegally bribe members of the U.S. Congress.

[29] In the 1920s, Ponzi paid very high returns by using newly received funds to pay off earlier investors, effectively creating a pyramid scheme. Kreuger formed a trust to control all aspects of the production of matches in Sweden and later throughout the world; speculation and fraudulent practices during the 1920s wrecked the trust and led to Kreuger's suicide. Whitney was indicted and pled guilty in the 1930s to the misuse of funds; the reform of the practices of the New York Stock Exchange resulted from his actions.

PART I:
The Chronology of Business Regulation

The senior executives of the Megafinancial Corporation (MegaFi) are attending their regular weekly strategy meeting chaired by the company's president and CEO, Seymour Dough. The major agenda item is the consideration of a new product idea sponsored by the Vice President for Marketing, Will Sell. MegaFi is a leader in the global financial markets in securities, insurance, and banking but is facing increased competitive pressures and additional scrutiny from regulators in the major developed countries.

The new product – Guaranteed House Sale – is intended to solidify the company's position in real estate by offering a variation on traditional residential property sales. The concept is a sale based on the appraised value of the property but with a guarantee of 75 percent of the average annual increase in property value experienced in the property's market area (for example, in the county or zip code location in the U.S.). The increase or decrease would be determined from transactions for equivalent property from sales data as recorded by a local board of realtors.

In an example provided at the meeting by Will Sell, a house owned for ten years with a $300,000 mortgage (based on an original appraisal of $400,000) could be sold back to MegaFi at a guaranteed average annual gain of 6 percent, which is 75 percent of the area's residential property increase of 8 percent. The homeowner would net $446,400[1] without having to go through the process of selling the house or paying a real estate agent's commission (6 percent in most places in the United States), and without risking a price reduction due to a temporary market decline. MegaFi would then be able to sell the house for whatever price the market sets, presumably $863,600,[2] through its real estate agency, without paying any agent's commission (as all of the company's agents are salaried).

Of course, the homeowner could always choose to sell his house through the conventional process, but he might experience delays in listing time, showing time including open houses, mortgage contingency and inspection time for the buyer, and closing time. The obvious advantage to MegaFi is the potential profit of nearly $150,000;[3] the benefit to the homeowner is a guarantee executed at the time of the original purchase of 75 percent of the appreciation of equivalent property and no waiting period to complete the transaction.

[1] Calculated as $400,000 times the future sum factor of 1.791 (6 percent, ten years), or $716,400, less $270,000 (the amount of the original mortgage less an assumed $30,000 paid off by the mortgagee in regular monthly payments).

[2] $400,000 times an average annual increase of 8 percent, or $863,600, calculated as $400,000 times 2.159 (the future sum for 8 percent and ten years).

[3] $863,600 less $436,400<<Should $436,400 here be $716,400?>> = $147,200; this calculation excludes the repayment of the outstanding mortgage loan.

Will Sell is particularly enthusiastic about Guaranteed House Sale, because MegaFi is facing cutthroat competition in the traditional mortgage lending business. Furthermore, the company can insist on writing the homeowner's property insurance as an integral component of the deal, and once insurance is included, other types of policies can be offered, such as life, disability, long-term care, liability, and even automobile coverage. Typical insurance pricing provides discounts for multiple policies, an attractive feature for insureds.

Sue Lawless is the senior attorney in attendance. She listens carefully to Will's presentation, taking careful notes as his idea is explained. As discussions

proceed, Sue explains that the concept probably involves components of banking, insurance, securities, and real estate, and if the plan is implemented in the U.S., it could require approvals and oversight of an array of federal and local agencies, including the Comptroller of the Currency, the Securities and Exchange Commission (SEC), the Federal Home Loan Bank, the Federal Trade Commission, state banking regulators, state insurance commissions, and local real estate boards. Seymour, Will, and the other attendees are astonished to learn of this situation and wonder how American industry could have become so ensnarled in regulation.

CHAPTER 2: ANTITRUST

Still one thing more, fellow citizens – a wise and frugal government … which shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities.
Thomas Jefferson (1743–1826), *"First Inaugural Address"*

In Chapter 1 we introduced the subject of business regulation, noting that the first significant laws were the Interstate Commerce Act of 1887 and the Sherman Act of 1890. America was rapidly changing from a frontier economy, composed largely of farmers, ranchers, and small merchants, to big industry and what was soon to become big government.

ANTITRUST IN 1890 AND IN THE TWENTY-FIRST CENTURY

In 1890, protections were thought necessary to prevent abusive behavior by unscrupulous corporate executives, particularly as there was only limited competition from foreign companies due both to distance and such trade restrictions as tarviffs and quotas. In 2007, there are unsolvable problems in applying antitrust that no one anticipated more than 115 years ago.

IS SIZE EQUIVALENT TO MARKET DOMINANCE?

More than a century later the world has changed completely, and we have to at least consider whether the old remedies for anticompetitive behaviors are still appropriate. Consider two rather prominent examples of recent corporate experience.

- General Motors in 1978 controlled 47.7 percent of the automobile market in the U.S.; by 2003, its market share had fallen to 25.7 percent.[1] Was GM restraining trade in 1978? What changed GM's behavior? Was it concern about antitrust, or did the superior products and service of Japanese and other manufacturers simply grab market share?

- Wal-Mart has a 21.7 percent share of the entire U.S. retail market.[2] Is Wal-Mart restraining trade by being more efficient than its competitors, using a real-time inventory management and ordering system, and insisting on low purchasing costs? Or is it simply smarter and more aggressive? And doesn't the consumer benefit by having low prices and a wide product selection?

As a nation, are we better or worse off with a General Motors in decline and a Wal-Mart in ascendance? Should regulation be used to substitute for the power of "the invisible hand," in Adam Smith's famous phrase?

Making the situation even more difficult was the inability of Congress to write the Sherman Act citing any specific violations. Instead, very general language was used that proved to be grist for more than a century of conflicting decisions by the federal courts.

- Section 1 of the Sherman Act outlaws restraints of trade: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."
- Section 2 deals with monopoly: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony."[3]

As Phillip Areeda notes, "the statutes … are so general that antitrust law shares a great deal with the common law,"[4] that is, law based on the decisions of courts rather than on the language enacted by Congress.

"FIXES" TO THE SHERMAN ACT

There have been various attempts to make antitrust more specific in subsequent legislation; for a list see Figure 2-1. The Clayton Act of 1914 cites illegal anticompetitive behaviors, including prohibitions against exclusive sales contracts, local price cutting to freeze out competitors, rebates, and interlocking corporate directorates.[5] (An interlocking corporate directorate is where two or more companies have common individuals serving on the Board of Directors and perhaps influencing decisions in favor of the other company.) Because specific actions were clearly defined in the Clayton Act, it became the basis for several important cases brought against large corporations.

FIGURE 2-1:
ANTITRUST LAWS

Legislation	Purpose
Sherman Act (1890)	Sets a competitive business system as national policy, specifically banning monopolies and restraints of trade
Clayton Act (1914)	Places restrictions on price discrimination, exclusive dealing, tying contracts, and inter¬locking boards of directors that reduce competition or might lead to a monopoly
Federal Trade Commission Act (1914)	Establishes the Federal Trade Commission (FTC) to investigate business practices; prohibits unfair methods of competition
Robinson-Patman Act (1936)	Outlaws price discrimination in sales to wholesalers, retailers, or other producers; bans pricing designed to eliminate competition
Wheeler-Lea Act (1938)	Bans deceptive advertising; assigns jurisdiction to the FTC
Celler-Kefauver Act (1950)	Closed the loophole in the Clayton Act allowing potential restraints of trade through acquisition of a competitor's assets
USA Patriot Act (2001)	Limits interactions between U.S. and foreign banks to those with "know your customer" policies; allows the U.S. Department of the Treasury to freeze assets and bar a country, government, or institution from doing business in the U.S.; gives federal authorities broad powers to monitor Internet usage

As a second line of enforcement for antitrust (after the Department of Justice), the Federal Trade Commission (FTC) was established as an independent agency of the U.S. government in 1914. The principal mission of the FTC is the promotion of consumer protection and the prevention of anticompetitive business practices. Subsequent legislation strengthened antitrust enforcement, including the Robinson-Patman Act of 1936 and the Celler-Kefauver Act of 1950.[6]

It is important to note that there has not been any significant antitrust legislation in more than fifty years. During that time, the U.S. lost its global dominance in nearly all manufacturing sectors, innovations in computers and telecommunications have revolutionized all phases of working and personal life, and there has been nearly universal acceptance of capitalism. Antitrust clearly assumes the economic structure of a developing yet isolated industrial society. However, there has been no government initiative in all this time to review or revise existing law or regulation.

PROBLEMS IN APPLYING THE ANTITRUST LAWS

The Supreme Court has somewhat resolved at least a part of the specificity problem by defining the goal of antitrust as maximizing "consumer welfare."[7] But in announcing this goal, other problems remain that we will briefly discuss in this chapter:

- How do we define competition?
- Do we protect those competing and/or potential new entrants to the market? What about competitors from outside the jurisdiction of U.S. law?
- Is the efficient allocation of scarce factors of production the issue?
- Should any potential trade restraint be prohibited, or only those restraints that are unacceptable?[8]
- Is any of this relevant in the twenty-first-century global business environment, particularly if international competitors refuse to follow the same rules?

Important antitrust cases did encourage competition, ending greedy business practices and creating a business environment that excluded monopolists and other undesirable business practices. However, there has been no single procedure in deciding antitrust cases over the past 100 years or so, as judges, plaintiffs, defendants, attorneys, and expert witnesses deal with the problem of interpreting these laws.

WHICH STANDARD OF REVIEW SHOULD BE USED?

The federal courts have constantly struggled with uncertainty over the appropriate standard of review to use in deciding an antitrust case. Do we condemn any potential restraints of trade or monopolies, or only those that have actually happened? If we prevent potential anticompetitive actions, we are acting against a crime that has not yet occurred. If we wait until the anticompetitive action occurs, innocent competitors and customers will have been injured, perhaps long past the point of being adequately compensated for their losses. An early case that addressed this issue was Standard Oil, which simply affirmed a lower court's finding[9] of a Sherman Act violation due to the creation of a holding company which could potentially restrain competition.

The evidence is contradictory as to Standard Oil's ultimate intent, and the passage of a century makes objective analysis very difficult.[10] At the time of the decision and despite years of inaccurate reporting by various observers,[11] there was no hard evidence of actual harm to consumers. In fact, the price of kerosene (the principal home energy source) dropped by 85 percent in the latter part of the nineteenth century, and there were over 100 companies competing with Standard Oil for U.S. business. However, Standard Oil received preferential shipping rates from U.S. railroads in exchange for volume commitments. In the decade before the passage of the Sherman Act, the company controlled much of the country's oil refining capacity, and it could have used this power to destroy competitors.

The creation of the crude oil pipeline system presented an opportunity for significant cost savings, but Standard Oil could only gain this advantage through centralized financial and operating decisions. It then expanded vertically by acquiring companies engaged in energy marketing and crude oil production.[12] Through this campaign of growth through consolidation, the company became fully integrated by the time of the passage of the Sherman Act, controlling about a three-fourths share of the oil refining market. Reviewing the Standard Oil history, it is difficult to find actual (as opposed to potential) harm to consumers.

Similar results can be cited for American Tobacco (1911), U.S. Steel (1920), Alcoa (1945), and other leading cases, with the Supreme Court at times reading the Sherman Act literally (the per se rule),[13] regardless of actual injury to competition, and at other times applying a "rule of reason" that limited findings of guilt to proven injurious corporation behavior.[14] Rule of reason analysis includes consideration of the facts specific to the business, the nature of the restraint and its effects, and the history and rationale for the restraint. Thus, American Tobacco was guilty, U.S. Steel was innocent, and Alcoa was guilty, even though the guilty were generally considered to be "good trusts."[15]

The per se rule allows courts to avoid the economic details; the rule of reason uses economic logic while placing a significant analytical burden on the judiciary. While courts often rely on expert testimony, each party usually has its own battery of authorities, and who does the court believe (particularly as so few judges are trained as economists)? Differences between per se and rule of reason are now less clear. In the language of a 1984 Supreme Court decision, "there is often no bright line separating per se from Rule of Reason analysis. Per se rules may require considerable inquiry into market conditions before the evidence justifies a presumption of anticompetitive conduct."[16] In fact, other standards exist on the per se and rule of reason continuum, including "quick look." If the outcomes from a potential antitrust violation are unclear, courts may make a shortened inquiry into the restraint's effects before deciding which analytical path to pursue.[17]

WHAT IS THE APPROPRIATE MARKET?

Defining the relevant market is often determinative in antitrust.[18]

Is Walgreen a drug store chain or part of the larger "food and drug store" industry?[19] Does it compete with CVS? Certainly. Does it compete with Kroger? This is a tougher question, because large supermarket chains have extensive pharmacy operations staffed with druggists and offering a wide variety of products. If the market is food and drug stores, the total revenues for the most recent reporting year were $276.7 billion (following the generally accepted convention of defining the size of a market by revenues).

However, if the market is drug stores, the total market was $90.9 billion.[20] And the answer makes a huge difference, because a hypothetical merger of Walgreen and CVS would constitute control of 75 percent of the drug store market and a clear target for antitrust review. However, that same merger measured against the food and drug store market would represent less than 25 percent of the industry's revenue and would almost certainly escape the government's opposition.

The economic solution in trying to define a market is to use elasticity of demand analysis to establish realistic competitive limitations. Price elasticity of demand is a measure of how much consumers respond in their buying decisions to a change in price; for example, a one percent increase in price that leads to a one percent in the quantity of product that is demanded is neutral (or unitary) in terms of revenue received. The demand for a good is inelastic if the price elasticity is less than one, meaning that some price increases can be tolerated by the market, yielding higher total revenues. The classic examples used in economics texts are the demand for salt or gasoline, where price increases (or decreases) will not significantly affect the quantity sold.

Elasticity is largely driven by the availability of substitute products. In theory, boundaries exist at the inflection point where low price elasticity of demand exists for the products in the market and the products outside it.[21] The Supreme Court has articulated this idea conceptually by noting that the "outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it."[22] But, how do we measure price elasticity in the absence of a practical methodology that is widely accepted by the economics profession? Although the concept is interesting and useful as a theoretical economic concept, no standard measure exists to calculate these outcomes.

FURTHER DEFINITIONAL ISSUES

Other ambiguities and problems continue to exist.

- What is the market being defined? Antitrust requires the monopolization or restraint of trade of a market. But in defining a market do we include –

    - Used goods? For example, do "formerly owned" cars (to use one company's euphemism) compete in the same market as new automobiles?

    - Imported goods? For example, for purposes of interpreting antitrust laws, do Nokia cell phones (manufactured in Finland) compete with Motorola cell phones (manufactured in the U.S.)?

    - Inter-product competition? For example, McDonald's hamburgers aren't usually considered as competing with Outback Steakhouse steaks, but they are when the customer is feeling economically stressed by high gasoline and home heating costs.

    - Competition from multinational corporations in international markets? For example, what is the market for Coca-Cola – only the U.S. (the legal reach of U.S. antitrust) or global markets including all foreign soda and beverage companies?

    - Competition from companies using e-commerce to serve distant markets? For example, what is the market for computer components when U.S. computer manufacturers can buy parts from U.S. suppliers or from their competitors in Taiwan, Singapore, or China?

- How do we account for nonprice competition, including innovation, advertising, service, and financing assistance? Any business manager can attest to the relatively inconsequential impact of price on the competitive position of a company, with the possible exception of those industries where products are essentially similar. Instead, companies compete today on quality, assured delivery, customer service, access to financing, and various other nonprice factors.

- What are acceptable degrees of concentration in each market? How are these limitations derived? Concentration measures are arbitrary and subject to statistical manipulation, and Justice Department limits on concentration are themselves totally arbitrary numbers with no theoretical or empirical significance.[23] Are six companies too many or too few? Or should the metric be the percentage of an industry controlled by the top one or two companies? The tobacco industry has only four competitors with the Altria Group's market share at 85 percent – is this too much concentration?[24] No one has suggested that we instigate antitrust proceedings against Altria to make the tobacco industry more competitive. For comparison purposes, Figure 2-2 lists selected industries and the market shares of the top one and top two companies. Which should we prosecute first?

Figure 2-2:
Market Share Data for Selected Industries
(data in billions $)

Industry (including Fortune Number)	Revenues of #1 Company	Revenues of #2 Company	Total of #1 & #2 Companies	Total Revenues of Public Companies	Market Share of #1 Company	Market Share of #1 & #2 Companies
#14: Diversified Financials			$181.5	$234.8		
-General Electric	$152.4				64.9%	77.3%
-American Express		$29.1				
#17: Electronics/ Electrical Equipment			$28.8	$61.7		
-Emerson Electric	$15.6				25.3%	46.7%
-Whirlpool		$13.2				
#48: Petroleum Refining			$418.8	$723.8		
-Exxon Mobil	$270.8				37.4%	57.9%
-Chevron Texaco		$148.0				
#62: Tobacco			$70.8	$75.7		
-Altria Group	$64.4				85.1%	93.4%
-Reynolds American		$6.4				
#68: Waste Management			$17.9	$20.6		
-Waste Management	$12.5				60.7%	86.9%
-Allied Waste Industries		$5.4				

Source: Calculated from data in the Fortune 500 issue of April 18, 2005

What do we do with a company like General Electric? Its market share of the Diversified Financial Industry is 65 percent, but is it a financial company like American Express? Based on its most recent financial statements, GE's industrial segment contributed 54 percent of total revenues, while GE Capital contributed 46 percent.[25] Perhaps we should break up GE, forcing it to divest its financial businesses – remember it has a 65 percent market share. But anyone who has studied the company's success over the past decade knows that GE Capital is a major factor in the sale of its industrial equipment. And by the way, why does Fortune magazine list it as a Diversified Financial?

Finally, what do we do with privately held companies? Certainly antitrust laws make no distinction between public and private enterprise, although all of these statistics focus on published financial statements. The waste disposal subcategory within waste management, which is one of those industries included in Figure 2-2, has over 100 companies that are not included in the Fortune 500 list. And other subindustries would probably drive the total number of companies to over 500.[26] How does this get counted in these concentration calculations?

- How is competition encouraged if mergers and other strategic initiatives are restricted? Major companies would be effectively protected in many markets if new competitors – perhaps created from the remnants of smaller firms – could be subject to antitrust review. Or should we subject the existing companies to antitrust scrutiny in the effort to bring in new competitors?

- What are the barriers to entry and exit? If an industry – such as airlines or banking – restricts new participants because of market, legal, and/or financial requirements, wouldn't the position of consumers be improved by encouraging existing participants to survive and grow?

In addition, what are the synergies of the companies considering a new venture? For example, does the acquired firm bring new technology or innovative processes to a complacent acquirer, thereby enabling the new entity to better compete in the global economy?

- Is the proposed merger horizontal or vertical?[27] Horizontal mergers have typically been considered as "dangerous."[28] If Hewlett-Packard and COMPAQ were to merge (which they did in 2002 with less-than-outstanding results), the result might harm competition. Following this "logic," if COMPAQ and Intel were to merge, the result would be benign. Does anyone really believe this?

The following comment by Frederick Rowe gives some indication of the complexity in any attempt at "logical" analysis.

> More and more, fixation on market shares and concentration levels degenerated into "numbers games." The Justice Department hit mergers threatening to raise concentration in markets for "frozen dessert pies," for "artificial Christmas trees," for "vandal-resistant plumbing fixtures" used in prisons, for local towel rental services, for "custom-compounded reinforced thermoplastics," for drapery hardware, or for commercial trash hauling in Dallas. The Federal Trade Commission moved against mergers threatening to raise concentration in markets for frozen pizza, for carburetor kits, for urological catheters, and for "knockdown casket parts."[29]

MORE PROBLEMS IN APPLYING ANTITRUST

In addition to confusion in understanding the structure of an industry, there are other issues to consider. These include alternative economic theories, in the timeliness of the outcome, and global variations in application of antitrust law.

THE CHICAGO SCHOOL

The Chicago school has provided a leading economic methodology in the analysis of antitrust.[30] The approach is fairly straightforward and reflects classical economic theory: scarce factors of production – land, labor, and capital – are most efficiently allocated in the presence of competitive markets. That is, forces of supply and demand function to clear markets at prices and quantities set by the marketplace. This principle seemingly assures that costs and prices will be kept low, that companies will attempt to innovate and develop new technologies, and, most important in considering antitrust, competition will be fair to consumers.

A significant problem with the Chicago approach is that efficient markets do not necessarily consider how equitably products and services are distributed among participants. Robert Bork has written that the "whole task of antitrust can be summed up as the effort to improve allocative efficiency."[31] In other words, the Chicago school seems to equate consumer welfare with efficiency. However, the leading federal cases have never turned on efficiency, and in fact tend to focus on wealth distribution and economic concentration.[32] Congress intended to prevent the exploitation of consumers through predatory (below cost) pricing[33] operated through oligopolistic market control. Despite these limitations, some cases decided in the decades of the 1970s and 1980s were influenced by the Chicago school.[34]

Furthermore, classical supply and demand is essentially static, ignoring how companies and consumers actually behave in a competitive environment. Some authorities look to behavioral economics, which is concerned with how a decision-making process influences the choices that are eventually reached.[35] An important question is: are the utility or profit maximization assumptions in classical economics good approximations of real behavior? It is clear that actual behavior departs from that of the "rational actor" assumed by standard economic models. Behavioral economics attempts to develop a systematic approach to the application of economics to these deviations from standard assumptions. There have been no cases that consider this approach in antitrust review; however, a leading judge has written on the topic and there is the possibility of future consideration.[36]

THE POST-CHICAGO AND VIRGINIA SCHOOLS

More recent economic analysis, sometimes called "post-Chicago," overcomes the static framework of Chicago analysis through game and information theory.[37] This approach attempts to consider the sequencing of market entrants, the anticipated reactions of competitors, the advantages inherent in being an incumbent, and the insurmountable barriers to entry in certain old and most new economy industries.[38] The Virginia school – often called "public choice" – argues that antitrust should be abolished, as the interests of consumers have consistently been left unprotected and competition has been reduced rather than enhanced.[39] Their review of specific cases and more systematic evidence indicates that antitrust does not help competition but actually reduces it.[40] For public choice, a deregulated world of private contracts is preferable to government intervention.

To this point the government has not adopted the public choice philosophy and continues its antitrust enforcement. However, this is a somewhat "hollow" policy; whether there is active or passive enforcement depends largely on the political party in power and on the attitude of the judiciary. For example, several commentators have noted the laissez-faire antitrust profile during the 1981–1989 Reagan Administration.[41] In the present day, the Rehnquist court did not hear a merger case after 1974, resulting in the problems of ambiguity in legal standards and forum-shopping among attorneys.[42]

WILL A TIMELY AND LOGICAL OUTCOME BE ATTAINED?

Antitrust cases can require a decade or more to prepare and decide. After years of consideration, the recent Microsoft case was originally brought in 1998, was first decided by one federal district court in 2000, was appealed to the U.S. Court of Appeals, was remanded to for retrial in 2001, and was finally decided in 2002.[43] The government alleged that Microsoft illegally tied its Web browser to the Windows operating system, despite the fact that injury to consumers was never proven. Numerous cases have similar histories as the judicial process slowly wends its way through fact finding, analysis, discovery, motions, and trial. Markets move faster than antitrust, and a shrewd litigation team can drag out the process for a much longer time than the life or death of a competitor.

A somewhat more subtle antitrust issue in the concern for timeliness is the fairly narrow perspective required for deciding legal conflicts. The plaintiff (sometimes the federal government) brings allegations that one or more antitrust laws have been broken, and the defendant attempts to rebut these specific accusations. There is little consideration for the general characteristics of the industry, for competitors, or for other factors economists typically examine in analyzing a market. Oligopoly is the predominant form of industrial structure and is a natural result of the requirement for economies of scale in plant, equipment, intellectual property, and marketing capacity. Yet

courts often focus on whether a past harm has occurred despite the natural tendencies of markets toward efficient behavior.[44]

The twenty-first-century new or postindustrial economy involves global competition in industries that focus on intellectual property, as opposed to a manufactured product. Data and technology are used to produce information systems, financial services and scientific discoveries. Such new economy industries as computer software, Internet-based services, and telecommunications initially require very high capital investment in networks, intellectual property, and computer systems.[45] These technologies were obviously never contemplated by the 1890 authors of the Sherman Act, who did not see industrial competition and economies of scale as mutually exclusive.

The "new" economy requires the accumulation of capital or scale outcome that presents barriers to entry to aspiring competitors and often requires nearly total control of an industrial sector (such as is the situation with the telecommunications industry),[46] while creating the risk of predatory pricing. The Microsoft case illustrates the challenges facing courts attempting to reconcile innovation, the scale requirements of a new economy industry, and antitrust. Many economists today have accepted that Schumpeterian "creative destruction"[47] is inevitable and can disrupt competition in high technology markets with long-term positive effects.

HOW DO OTHER COUNTRIES VIEW ANTITRUST?

An interesting irony is the strong influence of the U.S. on European Union (EU) policy and the resulting current enforcement of EU antitrust. Microsoft experienced a relatively benign result in the U.S. cases brought against it (as discussed earlier in this chapter), while the EU is still aggressively pursuing the company. Microsoft's strategy in Europe has been to place its operating system into just about every application: corporate networks, consumer electronics, and the Internet. However, in 2004 the EU found that the company had abused its dominant position, resulting in an antitrust fine of nearly 500 million euros. While the EU actively pursued Microsoft, the George W. Bush administration defended the company and, in the words of Harry First, was "far less concerned about single-firm dominant behavior than previous administrations."[48]

It is no great surprise that Microsoft recently agreed to end its 9-year fight against the European Union's antitrust regulators.[49] The company simply got tired of fighting a system that claims to support competition without consideration for the realities of the marketplace. Will freer competition and better customer service result? There may be little actually gained because of previous Microsoft agreements with other computer companies for cross-licensing and the sharing of technology.

Developed countries in Asia have a benign attitude toward antitrust, unlike the current U.S. and European posture. Japan allows a cartel system known as keiretsu, which involves groups of financially connected companies that give first preference to doing business with each other rather than in an openly competitive system.[50] Historically, the keiretsu were supported by strong government central planning which directed financial institutions to support certain favored companies. Following World War II, the initial Allied intention was to dismantle these cartels, as they were thought to be critical elements in fomenting and then supporting the Japanese war effort. However, they were allowed to continue in existence due to the need for a strong U.S. ally as a first line of defense against the Soviet Union during the period of the Cold War. The fifteen-year Japanese recession that began in the 1990s has been largely attributed to mistaken investment and lending choices made under this arrangement, and, as a result, there has been some opening of the economy to more competitive market forces.[51]

WHAT THE U.S. SHOULD DO

In a democracy, the passage of a law – for whatever cause and due to whatever pressures – tends to be a permanent action. The principal reason is that there often are no constituencies demanding reexamination of the earlier decision by the legislature. Exceptions do occur, but they often take decades to ripen into action and can require enormous lobbying efforts by interested parties; we'll discuss the efforts required to change the laws on financial services in Chapter 4. The antitrust statutes have no wealthy constituencies demanding action, primarily because a merger or effort toward the control of an industry is often a one-time event in the life of a corporation. Those agitating for one fix or another are largely in academic positions, and they have little impact on Washington decision makers.

On balance, it is difficult to argue that the U.S. economic system would not proceed in a civil and orderly fashion in the absence of an antitrust shield. There has been no significant case in two decades on the domination of an industry by a single company or by companies acting in restraint of trade. The most recent landmark decision on antitrust – other than Microsoft – was possibly the case of AT&T.[52] However, in that situation the government had allowed a monopoly to continue for much of the twentieth century as an expedient to provide communications services to U.S. customers, and there is certainly no likelihood of a return to the control of that industry or any other industry in the sense of Sherman Act–type anticompetitive behavior.

TWENTY-FIRST CENTURY REALITIES

The concepts of monopoly and restraint of trade make sense when consumers have no choice in their sources of supply, as small businessmen and farmers discovered in the late nineteenth century. That situation has clearly changed in the early twenty-first century, and America is now scrambling to compete in global markets with international competitors who are not looking over their shoulders at antitrust regulators. It is not enough to approve actions that would have been challenged during previous times, as in the recent case of the Whirlpool-Maytag merger,[53] because the decision makers will change with each new national political agenda.

We have seen that the Republicans don't enforce antitrust, while the Democrats did during their time in the White House and probably will again. This inconsistency of enforcement is patently unfair to society and against the intent of Congress when it passes legislation. The antitrust laws cannot be made sufficiently specific to allow fair and consistent application, and, in any event, should not impede U.S. companies from developing strategies to allow them to compete in global markets. The time may have indeed come to consider repealing the antitrust laws.

ENDNOTES FOR CHAPTER 2

(Endnotes)

[1] Statistics are for U.S. dealer new light vehicle sales; S & P Industry Surveys [based on Ward's Auto Reports data], § AAP 5, 15-16 (2005).

[2] Statistics are derived from U.S. Department of Commerce data compiled by S & P Industry Surveys, § RG 8-9 (2005), for general merchandise, apparel, furniture, appliance, sporting, hobby, and miscellaneous sales. The next closest retailers in sales volume are Target and Sears, both with annual sales of one-fifth of Wal-Mart's.

[3] See 26 Stat. 209, 15 U.S.C. § 1.

[4] Phillip Areeda, "Monopolization, Mergers, and Markets: A Century Past and the Future," 75 California Law Review 959 (1987).

[5] See 38 Stat. 730, 15 U.S.C. § § 12-27, 29 U.S.C. § § 52-53.

[6] The Robinson-Patman Act, 38 Stat. 730, 15 U.S.C. § 13 (1936); the Celler-Kefauver Act (also known as the Anti-Merger Act), 64 Stat. 1125, 15 U.S.C. § 18 (1950).

[7] This concept has been reiterated in numerous cases decided by the Supreme Court; e.g., "the unrestrained interaction of competitive forces will yield the best allocation of our economic resources … the policy unequivocally laid down by the Act [the Sherman Act] is competition." N. Pac. Ry. Co. v. U.S., 356 U.S. 1, 4 (1958). See also U.S. v. Citizens & So. Nat'l Bank, 422 U.S. 86 (1975); Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979); and Nat'l Collegiate Athletic Ass'n. v. Bd. Of Regents of the Univ. of Okla., 468 U.S. 85, 107 (1984).

[8] This is the theory of "the rule of reason" first articulated in Standard Oil Co. v. U.S., 221 U.S. 1, 56, 64, 77 (1911). The Standard Oil case is noted in the next section.

[9] The federal judiciary generally comprises three levels of review: district courts that initially hear cases; circuit courts that review appeals from those decisions; and the Supreme Court, which, at its discretion, hears appeals from circuit court decisions.

[10] Much of the following is from Alfred Chandler, The Visible Hand: The Managerial Revolution in American Business (1977), as supplemented by Dominick T. Armentano, Antitrust and Monopoly: Anatomy of a Policy Failure (1982).

[11] As one recent example, see James M. Day, Oilmen and Other Scoundrels (2004). In addition to the title, the material on Standard Oil (Part II) includes such chapters as "The Octopus Spreads Its Tentacles" (Chapter 4) and "The Bigger, the Better, & the Baddest" (Chapter 5). No need to worry about objective reporting here!

[12] Vertical integration refers to an expansion strategy of either acquiring or developing earlier or later stages in a business cycle. For example, General Motors could acquire companies that manufacture raw materials used in automobile production, such as tires or sheet steel. This is referred to as "backward vertical integration." It could also acquire local dealerships that sell at retail. This is known as "forward vertical integration."

[13] Using the per se (Latin for "by itself") rule: meaning inherently and without the need for further explanation or analysis.

[14] See Standard Oil Co. of N.J. v. U.S., 221 U.S. 1 (1911); U.S. v. Am. Tobacco Co., 221 U.S. 106 (1911); U.S. v. Aluminum Co. of Am., 148 F.2d 416 (1945).

[15] See, e.g., the findings of the lower court in U.S. v. Aluminum Company of America [Alcoa], 44 F.Supp. 107.

[16] Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of the Univ. of Okla., 468 U.S. 85, 104 (1984).

[17] See, e.g., Cal. Dental Ass'n v. Fed. Trade Comm'n, 526 U.S. 756, 779 (1999) ("The truth is that our categories of analysis of anticompetitive effect are less fixed than terms like 'per se,' 'quick look' and '"ule of reason' tend to make them appear"). There have been various Supreme Court comments on "quick look," including FTC v. Indiana Fed'n of Dentists, 476 U.S. 447 (1986); Chicago Prof'l Sports Ltd. P'ship v. NBA, 961 F.2d 667, 676 (7th Cir. 1992) cert. denied, 506 U.S. 954 (1992); and Cal. Dental Ass'n v. FTC, 526 U.S. 756 (1999).

[18] See Frederick M. Rowe, "The Decline of Antitrust and the Delusions of Models: The Faustian Pact of Law and Economics," 72 Georgetown Law Journal 1511, 1512-13 (1984); and Robert Pitofsky, "New Definitions of Relevant Market and the Assault on Antitrust," 90 Columbia Law Review 1805, 1807 (1990).

[19] This is the category used in the Fortune 500 annual list; see Fortune, April 18, 2005, Table 24, F-53. All statistics in this section are derived from this report.

[20] Comprised of Walgreen, CVS, Rite Aid, Longs Drug Stores, and Duane Reade.

[21] The basic formula used to determine price elasticity is elasticity = (percentage change in quantity) ÷ (percentage change in price).

[22] Brown Shoe Co. v. U.S., 370 U.S. 294, 325 (1962). A merger of two companies may substantially lessen competition or tend to create a monopoly in the production,

distribution, and sale of shoes, in violation of § 7 of the Clayton Act of 1914. The District Court found that the result might substantially lessen competition, which result was affirmed by the Supreme Court.

[23] The Herfindahl-Hirschman market concentration index (HHI) is often used to calculate market share, with higher levels of concentration possibly triggering antitrust investigation. See U.S. Department of Justice, Herfindahl-Hirschman Index, at www.usdoj.gov/atr/hhi.htm.

[24] See the calculation of market share in Table 2-2; the tobacco is industry number 62. Fortune 500 issue, Fortune, April 18, 2005, F-66.

[25] GE's financial statements are available at www.ge.com/en/company/investor/earnings.htm.

[26] Privately held companies are listed in the Thomas Register (2005). Waste disposal is found in Volume 14. Other subcategories include chemical recycling and disposal, waste disposal equipment, engineering services: waste disposal, hazardous waste disposal, and toxic waste disposal.

[27] Horizontal mergers involve companies at the same level in the distribution channel within an industry; vertical mergers were defined in note 12.

[28] "[N]on-horizontal mergers are less likely than horizontal mergers to create competitive problems." U.S. Department of Justice, Non-Horizontal Merger Guidelines, at § 4.0; at www.usdoj.gov/atr/public/guidelines/ 2614.htm.

[29] Rowe, reference in note 18, at 1528.

[30] The Chicago school is named for the University of Chicago, which has influenced several members of the federal judiciary, including Robert H. Bork, former judge of the U.S. Court of Appeals (D.C. Circuit) and Supreme Court nominee; and Richard A. Posner and Frank H. Easterbrook, Judges, U.S. Seventh Circuit Court of Appeals.

[31] See Robert H. Bork, The Antitrust Paradox (1978), at 91. See also his comment "antitrust should concern itself solely with allocative and productive efficiency" (at 109).

[32] For two reviews of the legislative history, see Robert H. Lande, "Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged," 34 Hastings Law Journal 65 (1982); and Herbert Hovenkamp, "Antitrust Policy after Chicago," 84 Michigan Law Review 213 (1985).

[33] "Predatory pricing" is the practice of a dominant firm selling a product at a loss in order to drive some or all competitors out of the market or create a barrier to entry into the market for potential new competitors. It is considered illegal under current antitrust law. For a comment on predatory pricing in new economy situations, see Thomas A. Piraino, "A Proposed Antitrust Approach to High Technology Competition," 44 William & Mary Law Review 65, 126 (2002).

[34] See, e.g., U.S. v. General Dynamics Corp., 415 U.S. 486 (1974); Continental T.V. v. GTE Sylvania, 433 U.S. 36 (1977); and Matsushita Electric Industrial Co. v. Zenith Radio, 475 U.S. 574 (1986).

[35] For an overview, see Sendhil Mullainathan and Richard H. Thaler, "Behavioral Economics" (entry for the International Encyclopedia of the Social and Behavioral Sciences), at www.iies.su.se/nobel/ papers/ Encyclopedia%202.0.pdf. There are several articles in the legal and economics literature that apply behavioral economics

to the analysis of the likely behavior of participants in specific markets; e.g., Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC," 56 Stanford Law Review 1 (2003).

[36] Richard A. Posner, "Rational Choice, Behavioral Economics, and the Law," 50 Stanford Law Review 1551, 1573 (1998). See also Symposium, "The Legal Implications of Psychology: Human Behavior, Behavioral Economics, and the Law," 51 Vanderbilt Law Review 1495 (1998).

[37] For an overview, see Jean Tirole, The Theory of Industrial Organization (1988). There are several articles in the legal and economics literature that apply game theory to the analysis of the likely behavior of participants in specific markets; e.g., Paul L. Joskow, "Deregulation and Regulatory Reform in the U.S. Electric Power Sector" (in Deregulation of Network Industries, Peltzman and Winston, eds.) (2000).

[38] Supreme Court applications of post-Chicago analysis include Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985), and Eastman Kodak Co. v. Image Technical Sers., 504 U.S. 451 (1992). In both cases, the larger company was found guilty of interfering with and discouraged customers from doing business with the smaller company.

[39] The leading advocate is 1986 Nobelist James M. Buchanan. See Daniel A. Farber and Philip P. Frickey, Law and Public Choice (1991); and Fred L. Smith, "The Case for Reforming the Antitrust Regulations (If Repeal Is Not an Option)," 23 Harvard Journal of Law & Public Policy 23 (1999).

[40] See Smith, Ibid., at 23 (1999).

[41] See, e.g., David Millon, "The Sherman Act and the Balance of Power," 61

Southern California Law Review 1219, 1221 (1988); Thomas J. Campbell, "The Antitrust Record of the First Reagan Administration," 64 Texas Law Review 353, 361-64 (1985); and Albert A. Foer, "The Politics of Antitrust in the U.S.: Public Choice and Public Choices," 62 University of Pittsburgh Law Review 475 (2001).

[42] This problem is noted in "The Hands-Off Rehnquist Court," Business Week, July 25, 2005, 34-35.

[43] The tortuous history of the most recent case is U.S. v. Microsoft: 97 F. Supp. 2d 59 (2000); remanded by U.S. v. Microsoft Corp., 253 F.3d 34 (2001); decided at 215 F. Supp. 2d 1 (2002).

[44] For example, see Brown Shoe, reference in note 22.

[45] See James S. Sagner, Financial and Process Metrics for the New Economy (2001), Chapter 2.

[46] See Mark A. Lemley and David McGowan, "Legal Implications of Network Economic Effects," 86 California Law Review 479, 502 (1998): "The high fixed and low marginal costs of producing operating system software imply significant economies of scale."

[47] "The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process of industrial mutation – if I may use that biological term – that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in." Joseph A. Schumpeter, Capitalism, Socialism

and Democracy 83 (3d edition, 1950).

[48] First is a professor at the New York University School of Law and was the chief antitrust lawyer for New York State. Stephen Labaton, "Microsoft Finds a Friend in Bush," International Herald Tribune, June 11, 2007, 12.

[49] See Steve Lohr and Kevin J. O'Brien, "Microsoft is Yielding on Antitrust," The New York Times, October 23, 2007, pages C1, C8.

[50] A similar system – industrial conglomerates known as chaebol – operates in South Korea.

[51] For an explanation of the keiretsu economy, see any text on global business practice; e.g., Donald A. Ball et al., International Business, McGraw-Hill Irwin (9th edition, 2004), Chapter 13.

[52] U.S. v. Am. Tel. & Tel. Co., 552 F. Supp. 131 (1982). The breakup of AT&T was initiated in 1974 by the U.S. Department of Justice antitrust suit against the telephone monopoly. Under the terms of a settlement finalized on January 8, 1982, "Ma Bell" agreed to divest its local exchange service operating companies, and AT&T's local operations were split into seven independent Regional Bell Operating Companies (RBOCs) known as "Baby Bells." AT&T continued to operate all of its long-distance services, although it lost some market share in the ensuing years to various competitors. For an economic review of the situation, see Fred W. Henck and Bernard Strassburg, A Slippery Slope: The Long Road to the Breakup of AT&T (1988) (in the Contributions in Economics and Economic History Series, #80).

[53] See Diana B. Henriques, "U.S. Antitrust Review Backs Whirlpool-Maytag Merger," New York Times, March 30, 2006, C3 (reporting that the Justice

Department approved the merger because it would not significantly reduce competition among home appliance manufacturers).

CHAPTER 3: BANKING

A banker is a fellow who lends you his umbrella when
the sun is shining, but wants it back the minute it begins to rain.
Mark Twain (1835–1910), Attributed

In Chapter 1 we briefly mentioned commercial banking, the object of the first American regulation of business that began during the Civil War. Banks and other financial institutions that accept deposits are subject to extensive scrutiny by an array of government agencies because of the amount of their funding by the deposits of businesses and individuals. Some 90 percent of all bank capital is derived from deposits, with the remaining capital from stockholders' equity (stock).[1] In contrast, most manufacturing companies in the U.S. have about 35 to 40 percent in debt on their balance sheets. As can be imagined, even a few bad loans by a bank could cause that institution to fail.

THE DEVELOPMENT OF BANKING REGULATION

A series of banking panics and economic recessions occurred in the decades after the Civil War. The typical pattern was a failure by an individual bank due to the actuality or public perception of mismanagement or misguided lending practices; a run on that bank which had insufficient liquidity to repay depositors;[2] the bank's failure and the accompanying panic which would spread to other financial institutions; the withdrawal of reserves from the banking system leading to a shrinking loan volume; and, finally, economic recession. The U.S. was late in following other developed economies in creating a central bank to manage monetary policy and to be the "lender of last resort." The near collapse of the economy in 1907 and its rescue by an individual – J.P. Morgan – rather than by any government agency forced Congress to action.[3]

The Federal Reserve Act of 1913 created the Federal Reserve System, with the primary purpose of allowing loans to member banks to meet depositor and borrower demands.[4] The cycle of panic and recession led bank regulators to establish specific rules for lending, including limits on loans to specific customers and to industry groups. In the situation where a bank failure is threatened, the regulators can close the bank and authorize an orderly liquidation, sell portions of the bank's assets to other institutions, and/or lend funds to the bank (through the Federal Reserve's discount window) to assist until the emergency has passed.[5]

As we maintain throughout this book, it is vital to safeguard the individual depositor, borrower, and stockholder. For example, the creation of the Federal Deposit Insurance Corporation (FDIC) during the early years of the Roosevelt Administration was a brilliant concept to protect depositors and end runs on banks whenever the public perceived that their funds could be lost.[6] The current guarantee of $100,000 per depositor allows individuals and small businesses to safely expect that their funds will be accessible when a situation requires access to their cash. Federal Reserve regulations that also protect consumers include Regulation CC, which expedites depositor access to deposited funds; Regulation P, which protects the privacy of individuals, and Regulation Z, which prescribes uniform methods for disclosing the cost of credit.

THE BANKING REGULATORS

Banks are an essential lifeline for American and global companies because they supply a significant portion of long-term capital.[7] The corporate

bond markets are not nearly as well developed outside the U.S., resulting in a much higher rate of corporate lending through foreign banking institutions. Because of this vital role and given the unhappy economic history until the years after World War II, banks have been among the most regulated of all industries; see Figure 3-1. We will briefly note the functions of the two most important of the regulators: the Comptroller of the Currency and the Federal Reserve.

Figure 3-1:
Regulatory Responsibilities for Federally Chartered U.S. Banks

Activity	Agency Responsible
Chartering authority	Comptroller of the Currency
Supervisory and examining authority	Comptroller of the Currency
FDIC insurance	Comptroller of the Currency
Federal Reserve System membership	Automatic with charter
Approval for branch applications and for bank mergers	Comptroller of the Currency
Approval of bank holding company formations and acquisitions	Federal Reserve System
Financial holding company certification and prior notice of new activities	Federal Reserve System
Establishment of uniform principles and standards for the examination of financial institutions	Federal Financial Institutions Examination Council

The Comptroller of the Currency is the agency within the Department of the Treasury that supervises the operations of nationally chartered banks. The Comptroller's powers include the chartering of national banks, the review of national bank merger applications, the implementation of regulations, the examination and supervision of national banks, and participation (through a board directorship position) in the management of the FDIC. Compliance with regulations is achieved through cease and desist orders; the removal, suspension, and/or fining of bank officials; the replacement of a bank's management with a trustee; and, if necessary, the revocation of a bank's charter.

In addition to its critical role in managing U.S. monetary policy, the Federal Reserve ("the Fed") is the primary supervisor and regulator of bank holding companies (any corporation that has control over a bank, usually requiring ownership of 25 percent or more of the bank's stock). As an indication of this power, bank holding companies include over 95 percent of all U.S. bank deposits. The Fed reviews expansion proposals and is assigned responsibility for supervising the overall banking organization. The Fed's powers are similar to those of the Comptroller of the Currency.

Congress has moved toward a more nationally competitive posture for banking in the past quarter century. Driving this trend was computerization and the use of telecommunications in banking, the need for equal treatment of banks and other financial institutions, and increased competition from foreign banks. Significant legislation affecting banking is listed in Figure 3-2. Although progress has been made in the deregulation of banking, there continue to be a few areas of banking regulation only impacting corporations that need to be considered for repeal.

Figure 3-2:
Recent U.S. Banking Laws

Legislation	Purpose
International Banking Act of 1978	Places foreign and domestic banks on an equal footing with respect to branching, reserve requirements,* and other regulations; increased the ability of U.S. banks to compete in international banking.
Financial Institutions Regulatory and Interest Rate Control Act of 1978	Increases the ability of regulatory agencies to prevent undue concentrations of bank ownership and management.
Depository Institutions Deregulation and Monetary Control Act of 1980	Equalizes reserve requirements across all insured depository institutions; eliminated interest ceilings on time and savings deposits; began explicit pricing of Fed services; made these services available to all depository institutions.
Garn-St Germain Depository Institutions Act of 1982	Increases the ability of regulators to aid distressed banks.
International Lending Supervision Act of 1983	Strengthens supervision and regulation of U.S. banks engaged in international lending.
Foreign Bank Supervision Enhancement Act of 1991	Expands authority over the review and approval of any form of foreign bank entry into the U.S., including supervisory oversight of banking operations, restrictions on permissible activities, and termination of any activities when deemed necessary; enacted due to increasing foreign bank operations.

****See note 2 for an explanation of reserve requirements.***

CHANGES IN COMMERCIAL BANKING

Commercial banking is the area of a bank that deals with providing lending and noncredit services to business customers. The early decades of the last century saw relative stability in this area of banking due largely to legislative restrictions on geographic and line-of-business expansion and few technological developments. As a result of this competitive inflexibility, depositors could expect to receive perhaps 3 percent as average interest and banks could charge 6 percent to corporate borrowers (and more to individuals except for mortgages). The resulting 3 percent or so of interest "spread" created a significant profit margin for relatively little effort; for a bank with a $100 million commercial loan portfolio, the gross profit was $3 million!

This happy situation (at least for the bank and its stockholders) began to change with the slow but steady erosion of competitive barriers. With new participants in the financial marketplace, bankers developed three general responses:

1. Noncredit Services. Banks have offered various for-fee products to business clients for most of their existence, including trust and shareholder services, and trade finance; see Figure 3-3 for a list.[8] Treasury management (originally called cash management) began to be a separate business in the 1950s, when banks offered such products as lockbox and various overnight investment instruments. By the 1980s, with high short-term interest rates and a growing emphasis on working capital, a full array of such services was marketed by the top fifty or so banks.

Figure 3-3:
Selected Noncredit Bank Services for Corporate Customers

Service	General Description
Payment and Collection	Depositing and clearing checks, effecting electronic transfers including ACHs and wire transfers
Treasury Information	Reports regarding the company's position with the banking community, including DDA balances, daily activity, foreign exchange quotes, and various other data
Investment Services	Various products including overnight sweep accounts, mutual funds, and long-term time deposits and certificates of deposit
Risk Management	Swaps, options, forwards, futures, and other derivatives to reduce or eliminate a customer's exposure to foreign exchange, interest rate, or commodity price risk
Capital Markets	Services associated with issuing commercial paper, the sale of loans, private placements, advice on mergers and acquisitions, and corporate structure
Trade Finance	Assistance in the financing and collection of trade obligations, such as letters of credit, documentary collections, and bankers' acceptances (BAs)
Agent and Fiduciary	Managing assets whose title remains with the owner. Examples of these services are: registrar, transfer agent, paying agent, custody services, corporate pension plans, qualified employee benefit plans, and corporate trustee
Shareholder Services	Providing the activities required by publicly held corporations in dealing with their shareholders, such as the payment of dividends and the solicitation of proxies at the time of the annual meeting

2. Profitability Analysis. Banks became sophisticated in their use of profitability models and have discovered that certain customers and products simply do not meet their return-on-equity targets. Given the amount of capital that must be committed to support a line of credit, banks have had to find other ways to make relationships sufficiently profitable to support lending activities. The term "relationship banking" has come to mean the entirety of the banking services provided to a client, and from the bank's perspective, the profitability generated. We will discuss some legal issues related to relationship banking in the sections that follow.

3. Mergers. Banks that could not compete were willingly or reluctantly courted by larger institutions that needed market coverage, a large depositor and lending base, and economies of scale in personnel and systems. The volume of merger and acquisition activity has been so great that banks with decades or even centuries of history have disappeared. For example, the author was an officer at the First National Bank of Chicago, founded in 1863, which was merged into Bank One in 1998 and then into J.P. Morgan Chase in 2004. Similarly, Manufacturers Hanover and Chemical Bank were merged in 1992 into what became Chase Manhattan (in 1996) and eventually J.P. Morgan Chase. As a result, the number of commercial banks has declined from over 14,000 in the early 1980s to about one-half that number today.

CREDIT RATIONING

One result of these changes has been the rationing of credit to corporate borrowers during periods of difficult business conditions.[9] Banks decided that it was no longer a viable strategy to subsidize the meager profits now being

earned on credit with the above-average returns earned on noncredit products, because competition had commoditized most of this business. Within months of the introduction of a new product, rivals throughout the industry would bring a new and improved version to market, often at a lower price. As a result, banks began to demand a greater portion of a company's financial activities, and companies were forced to reallocate their business to fewer banks.

Relationship banking is a long-established business activity. Indeed, the legislative history of the banking laws includes various positive references to this practice. For example, the Senate Committee Report on the Bank Holding Company Amendments Act of 1970 (BHCA) recognized that a customer should be able "to continue to negotiate with the bank on the basis of his entire relationship with the bank," and "where the customer uses multiple banking services ... the parties may be free to fix or vary the consideration for any services upon the existence or extent of utilization of such banking services."[10]

The preservation of relationship banking is generally viewed as positive by both customers and financial institutions for several reasons:

- A "partnership" perspective, developed over time, creating mutual synergy
- Efficient delivery of financial services saving time and transaction costs
- Comprehensive analysis of the credit risk of a customer, including the use of credit and noncredit services
- Negotiation of competitive pricing based on the volume and array of products purchased

- Generation of adequate return on capital to support credit facilities

TYING ISSUES IN BUSINESS AND IN BANKING

Courts typically examine all of the issues in such arrangements and apply a "rule of reason" that examines the market power and control of the seller. For example, in the Kodak case the Supreme Court found that the requirement that replacement parts would be sold only to the buyers of photocopiers constituted an illegal tying arrangement. The decision was based largely on rule of reason economic analysis, and found that there were significant life cycle costs that would affect the behavior of customers, forcing them to accept a higher price for servicing rather than change the equipment vendor.[11] A recent study of the practice of tying found the practice to be common in competition, with product-specific scale economies a major factor in making tying efficient and in reducing overall costs.[12]

THE STRICTER TREATMENT OF BANKS

This linkage of credit and noncredit services was addressed in a recent survey conducted of senior managers at several hundred companies. A major trade group, the Association of Financial Professionals, stated that nearly two-thirds of corporate financial managers report their companies were denied credit or that the terms of credit agreements were changed after noncredit business was awarded to other banks.[13] The results indicated that over half have been denied credit or have seen changes to lending terms because they did not purchase other services from their bankers.[14] A linkage of services is known in law as a tying arrangement, the demand by a seller that buyers also purchase another, often associated product. In the attempt to protect and promote competitive behavior, such "ties" have been illegal since the Sherman

Act of 1890 and the Clayton Act of 1914.

The BHCA[15] goes considerably further than the Sherman and Clayton Acts by making a tying arrangement illegal per se, that is, without regard to the economic impact of the seller or other rule of reason balancing.[16] The relevant language is as follows:

> A bank shall not in any manner extend credit … on the condition or requirement – that the customer shall obtain some additional credit, property, or service from such bank [or bank holding company].[17]

Congress did not intend to interfere with traditional banking activity;[18] instead, the objective was to prohibit anticompetitive practices that could force customers to accept certain services or to refrain from dealing with other financial institutions to obtain the desired services.[19] Statutory assurance was provided that the economic power of a bank in a community or region would not result in an unfair business practice.[20]

WHAT DO THE LAWS PERMIT?

A recent analysis concludes that there are seven possible relationship banking scenarios applicable to the BHCA, only one of which violates the antitying prohibition.[21] The six permitted situations are:

1. The customer requests multiple products.
2. The customer conditions the purchase of a bank product on obtaining additional product (a customer-initiated tie).

3. The bank terminates its relationship with an insufficiently profitable customer.

4. The nonbank subsidiary of a bank holding company conditions product on the customer obtaining additional product.

5. The bank conditions product on the customer obtaining a traditional bank product.

6. The bank conditions product on the customer obtaining either traditional or nontraditional bank products, at the customer's choice.

The seventh case – the tie of the desired product to a nontraditional bank product – is illegal because the bank has created a "condition or requirement" that customers must purchase an additional product.[22] Recent concerns about anticompetitive tying practices have focused on commercial loans to large, sophisticated companies. Borrowers in this market are often multinational corporations with the resources to negotiate on equal terms with banking organizations.[23] Loan syndicate members frequently include commercial and investment banks with no other relationship with the loan customer. Such independent participation in a syndicate makes it unlikely that the lead bank(s) would underprice a loan as a "loss leader" to secure additional business that would benefit only itself (themselves).

There are no legal cases that deal directly with the tying of credit and noncredit banking services in the sense of the concerns of the finance profession. A partial list of the "ties" to credit permitted by courts includes the purchase of real estate, guarantees of business indebtedness, relinquishing of financial control, requiring the services of a financial advisor or a management services arrangement, and the sale and leaseback of a building. Possibly the closest case in point to the tie of credit to a noncredit bank product found that

the company claiming injury was not required to contract all of its business to the specified financial institution, and so no violation occurred.[24]

WHAT IS APPROPRIATE POLICY?

The debate is ongoing as to whether tying exists. The General Accounting Office (GAO),[25] the Office of the Comptroller of the Currency (OCC),[26] and the Federal Reserve Chairman[27] have issued recent reports and communications on the issue of illegalities in the securing of corporate credit. However, to clarify its position, the Fed has issued proposed internal controls that banks should adopt to avoid any BHCA violations.[28]

Savvy bank attorneys instruct relationship managers (account officers) to avoid explicit statements demanding that clients purchase "linked" products, although there have been numerous instances where bank officers clearly indicate their expectations.[29] However, no company has instituted legal action under the BHCA, both from lack of documented proof (the so-called smoking gun) and the fear of antagonizing lenders. Regardless of the determinations of the GAO, the OCC, or the Federal Reserve, the real issue to be examined is: what is appropriate policy given the changes in financial regulation and industry structure since Congress passed the BHCA?

- Should tying arrangements continue to be a per se violation?
- Or should the concept of a rule of reason govern, with consideration for the market power of the bank?

Congress decades ago envisioned a parochial and limited banking structure that did not permit banks to engage in all types of financial services. When the original legislation, the Bank Holding Company Act of 1956,[30] was enacted, Congress decided that safeguards were needed against the undue concentration of bank power and control within a particular market area where an established local bank could deny credit to a company if a tied product was not also purchased. In that environment, there was limited competition in a market area, and businesses needed protection from unfair competitive practices. The BHCA specifically addressed tying arrangements and provided statutory relief if the economic power of a bank is misused. However, this was before the recent focus on deregulating financial industries.

IS THE BHCA BAD LAW?

In the current environment, the BCHA may be bad law for three reasons:

1. Economics. A banking market is no longer defined by geography. In today's deregulated environment, banks can and do enter any appealing market and depart from unattractive markets. Given this situation, Congress should reconsider whether tying arrangements should be per se violations. After all, it is the market power of the financial institution, and its potential to coerce anticompetitive behavior, that may restrain trade. With financial markets now open to all interested providers, the concern for control and intimidation is lessened.

2. Remedies. The BHCA directs the Department of Justice and the federal banking agencies to monitor bank behaviors, specifying that the OCC, the Federal Reserve Board, and the Federal Deposit Insurance Corporation "shall prescribe regulations establishing such procedures as may be necessary."[31] In addition, private parties can sue for injunctive relief.[32] While the civil penalties can be substantial,[33] judicial remedies require the expenditure of considerable time, effort, and money and will not provide much comfort to injured borrowers that are starved for credit. In fact, the complainant could be in dire financial straits or out of business by the time the case is heard and decided.

3. Equality of access. Through financial deregulation, Congress sought to increase competition and the efficiency of U.S. financial markets. However, the remnants of restrictions in such legislation as BHCA make banking subject to more stringent limitations than other financial service providers, such as investment banks and insurance companies, which are subject to lesser standards under the general antitrust laws.[34] This is not a "level playing field" with equal rules fairly applied to all participants.

OTHER REGULATORY ISSUES

There continue to be some minor issues which should be addressed in future banking legislation, including interest rate restrictions on corporate accounts, the general matter of bank charters, and the review of bank mergers.

INTEREST RATE RESTRICTIONS ON CORPORATE ACCOUNTS

Prohibitions on payment of interest on corporate demand deposits accounts (DDAs), which are also known as checking accounts, were legislated after the banking panics in the early 1930s.[35] These controls were used to limit interest rate competition among banks which had artificially raised interest rates to attract deposits, to preserve their liquidity and survival. Over the past several sessions, Congress has considered eliminating these restrictions;[36] however, they remain on the statute books and effectively force corporate treasurers to seek alternative uses of excess short-term funds.

To compensate corporations for DDA balances, banks developed the earnings credit rate (ECR), a noninterest credit which is used to pay for charges accrued for services rendered. The value of the earnings allowance is determined by multiplying the balance, less certain deductions such as required reserves, times the ECR percentage, which is usually derived from market rates on three-month U.S. Treasury bills. Balance credits are accepted as the method of bank compensation for several reasons, including:

- DDA balances are liquid and are immediately accessible in the event of a business need.
- Balance credits represent “soft dollars” and are not budgeted or otherwise subject to close review by senior management.
- Late cash in the corporate account, such as from wire transfer activity, may earn more from an ECR credit than from a late-day overnight investment.
- Balances may be required by the bank to support a credit line or to support a cash management service subject to debits (e.g., NSF checks redeposited), although this practice has largely disappeared.

The rising interest rate period beginning in the late 1970s made it apparent that the potential value of balances left at banks exceeded the credit received. Financial managers then began to consider paying for services in fees and managing down balances to minimal amounts.

SWEEPS

Banks assist treasurers in managing excess balances by offering sweep accounts, an investment mechanism that automatically moves balances from a DDA at the close of business, invests the funds overnight, and returns the investment to the account the following morning. Interest is calculated and paid on the invested balances daily. Sweeps have grown in popularity because of several converging pressures:

- The recognition that daily investment decisions involve transaction costs, both for wires or internal bank funds transfers and for the purchase and sale of the security, and the realization that the Fed’s 10 percent required reserves on balances earns no ECR credit.
- The promotion by banks of families of inexpensive sweep products, as contrasted to the traditional disdain for sweeps due to the negative impact on bank deposit balances. Various sweep alternatives, often managed as money market funds, include U.S. government instruments, repurchase agreements (repos), and commercial paper. Offshore sweeps (e.g., offshore Eurodollar deposits) offer attractive interest yields, unaffected by reserve requirements. Banks today can manage their balance sheets and derive fee income from sweep products, now estimated in the hundreds of millions of dollars per year, with typical fees of about fifty basis points on swept funds.
- The ongoing development of sweep products, which will make such products attractive alternatives to traditional investment vehicles. For example, some banks offer intraday sweeps to optimize interest yields in the prime late morning time period; tiered sweeps, with

predetermined amounts going to overnight funds and the balance to a long-term U.S. government fund with higher yields; and even "real time" sweeps, with intermittent funds investment of available funds.

- Low short-term money rates in recent years, with Federal funds between 1 percent and 4.25 percent in the May 2001–December 2005 period.[37] In this interest rate environment, the marginal gain from direct investment activity is too small to be worth the effort. In addition, the attempt to invest at optimal rates requires decisions by late morning, whereas funds may be credited to a DDA anytime during the day.

The restriction on paying interest on corporate DDAs is an anachronism from seven decades ago. While the concept may possibly have been valid in times past, there is no reason to force corporate treasurers and bankers to find end-runs around an arbitrary restriction that is impossible to justify in the current economic environment. Furthermore, this regulation probably harms smaller companies more than large multinationals, because the former are unable to take advantage of sweeps, direct overnight investments, or careful management of bank balances.

BANK CHARTERS

Bank chartering rules were established to ensure sound banks and stable banking markets. The prospect of dishonest behavior or of banks operated by inexperienced management justifies review of bank charter applicants. The Comptroller of the Currency investigates such attributes as the proposed capital structure and prospects for profitable operations, and the experience and integrity of directors and officers. However, restrictive chartering provisions

can limit competition and reduce market pressures on existing institutions. While no changes are proposed in chartering rules, bank regulators must be cognizant of the need to create a system that permits active financial market competition while also protecting depositors.

BANK MERGERS

Banking has its own legislation governing mergers, the Bank Merger Act of 1966 (as amended).[38] This law was passed at a time when there was confusion as to whether antitrust applied to banking, and it requires that the Department of Justice and the agency that would supervise the surviving banking organization pass on the merger based on various criteria regarding the resulting competitive situation in the market area of the banks affected. The HHI previously discussed and criticized in Chapter 2 is used in this analysis.[39]

It is particularly ironic that geography is the primary definition of the market, as banks can easily do business in any part of the U.S. or the globe using electronic communications. Furthermore, some mergers that have resulted in near-monopoly conditions have been allowed to proceed. For example, the merger of Fleet Financial into Bank of America in 2004 effectively eliminated commercial banking competition for the large corporate customer in the Northeastern states.[40] The recent acquisition of MBNA by Bank of America results in just under 10 percent of all deposits in U.S. banking being in that institution. Regardless, the Federal Reserve approved the merger, stating that it "would have no significant adverse effect on competition or on the concentration of banking resources in any relevant banking market and that competitive factors are consistent with approval."[41]

WHAT THE U.S. SHOULD DO

Bankers have been pulled into the world of business competition by a series of structural transformations that were inevitable yet necessary for the survival of the industry. Among the change factors affecting commercial banking have been:

- Technology. Most transactions today are initiated through dedicated treasury workstations, through data terminals (like Bloomberg), or, to an increasing extent, through the Internet. Banks no longer see their corporate customer except at times of credit reviews, when service changes are being discussed, or on relationship sales calls. Because of the widespread use of electronic funds transfer mechanisms,[42] about the only reason to visit a bank for transaction business is to deposit checks.[43]

  The most significant impacts of technology have been to greatly reduce the costs of banking, which have been largely passed along to corporate customers, and to make geographic boundaries irrelevant. A corporation in Northern California can transact business through banks in New York and Chicago without any effort or difficulty and with few service problems. The remaining technological issues relate to activities that have been traditionally paper-based, such as disbursement checks and letters of credit, and the current trend is clearly toward reducing the use of the paper form of these transactions.

- Competition. In the past, banks accepted deposits and made loans, securities firms sold stocks and bonds, and insurance companies wrote policies and collected premiums. The old product

boundaries no longer exist, and banks have been forced to learn to compete or become the target of a corporate takeover. Industrial loan banks established by corporations and beyond the reach of traditional federal regulation now have assets of nearly $150 billion.[44] Some banks have responded by aggressively acquiring other institutions, including Wachovia Bank's expansion throughout the Southeast and into New York. Others refocus on specific market sectors, for example, Mellon Bank's focus on the commercial market and its sale of its retail operations. Others have extensively worked a particular industry segment, such as State Street Bank's emphasis on insurance and mutual funds.

- New products. Various new financial instruments have been developed in recent years, including products to manage interest rate and foreign exchange rate risk, option and hedging strategies, and derivatives. This latter category has been particularly attractive to bankers and their corporate customers because they permit a risk to be divided into components, for example, the principal and interest portions of a fixed-rate loan. This allows financial managers to retain or hedge against price movements for specific elements of the risk.

  Other products include securitization of loans or other debt which experiences regular, periodic payments;[45] various checking account products, such as the sweeps discussed earlier; and comprehensive payables, a product that allows the bank to accept a file of disbursements from a corporation and handle the entire issuance (including the remittance advice), funding, and reconciliation. Banks are even being permitted to develop and own hotel and office properties, which may open the possibility of entering the commercial real estate business.[46]

These changes have so far required some three decades for corporations and banks to absorb, with further developments likely to occur. This was not the easiest of transitional periods, particularly given the widespread problems during the period of 1980 to 1995 involving bank failures[47] and the near depletion of the FDIC insurance fund. However, unlike the airline industry (to be discussed in Chapter 5), banking was never in danger of widespread collapse or bankruptcy filings, threatened job actions by militant labor unions, soaring costs of jet fuel, or the expense of instituting universal security procedures.

WHAT THE U.S. SHOULD DO

Various proposals have been floated for refinements to current banking regulation, generally focusing on increased market discipline, better risk management, and more effective supervision.[48] Less or minimal regulation may be the better alternative, allowing banks the freedom to compete with all other companies that require lender (depositor) and investor capital. The financial markets perhaps provide the best indication of the position of banking in the context of the perception of efficiency, performance, and creditworthiness. Banks currently trade at 211 percent of book value, the lowest of all U.S. industries (except for insurance and thrifts).[49] This is despite two competitive strengths that should attract bank investors:

- The possibility of being acquired. Because of the changes in the laws regarding lines-of-business and geographic market areas, banks are constantly being considered for acquisition. The remaining independent banks are generally in attractive market areas, are profitable, and should be but are not trading at prices above 300 percent of book; see Figure 3-4 for a listing including individual and average market-to-book values.

Figure 3-4:
Market Value-to-Book Value for Independent Commercial Banks

AmSouth Bancorporation	259
BB&T	208
Comerica	187
Commerce Bancorp	276
Compass Bancshares	271
Fifth Third Bancorp	238
First Horizon National	217
Huntington Bancshares	209
KeyCorp	180
M&T Bank	209
Marshall & Isley	222
National City	165
North Fork Bancorporation	139
PNC Financial Services Group	223
Popular	195
Regions Financial	145
SunTrust Banks	157
Synovus Financial	306
TD Banknorth	80
UnionBanCal	230
Westcorp	229
Zions Bancorporation	227

Note: The list excludes banks with stock market values over $50 billion.

Source: "Outlook Scoreboard 2005," Business Week, December 26, 2005, 138.

- Superior returns. The total return on banks in the most ten-year reporting period was 19 percent, the fifth highest among all U.S. industries.[50] Total return includes dividends and growth in the value of the corporation's stock.

Eliminating regulatory uncertainties in dealing with business customers might significantly help to improve perceptions of the commercial banks. If depositor and stockholder protections remain in force, the next appropriate step for Congress may be to eliminate the restrictions on bank tying arrangements, on corporate DDA interest, and on bank mergers and allow the same legislative approach and judicial remedies that are applied to other industries.

ENDNOTES FOR CHAPTER 3

(Endnotes)

[1] For 2004, the debt-to-asset percentage (debt ratio) for commercial banking was 90 percent. In contrast, computer manufacturing was 55 percent, and health and personal care retailing was 48 percent. Debt-to-assets and other ratios are available by industry in Leo Troy, Almanac of Business and Industrial Ratios (2005).

[2] Fractional banking is the nearly universal practice of banks retaining only a fraction of their deposits and notes as reserves to satisfy demands for withdrawals and using the remainder to lend to develop interest income that can be used to pay interest to depositors and provide profits for the banks' owners. The measure used to analyze commercial banks is the reserve ratio, which is the ratio of reserves to demand deposits (checking accounts) and notes; in the U.S. the current reserve requirement (as set by the Federal Reserve) is 10 percent.

[3] For a brief history of J.P. Morgan's role in the 1907 situation, see Charles R. Geisst, The Last Partnerships (2001), Chapter 5.

[4] Dispersed throughout 12 U.S.C.; 38 Stat. 251 (1913). For an explanation of the Federal Reserve's role in managing monetary policy, see any introductory economics text, for example, Robert Frank and Ben Bernanke, Principles of Economics (2nd edition, 2003), Chapter 14.

[5] Discount window lending by the Federal Reserve allows banks to borrow reserves. The interest rate charged is called the discount rate.

[6] Section 8 of the Banking Act of 1933, 48 Stat. 162, codified at 12 U.S.C. 227, amended the Federal Reserve Act to create the Federal Deposit Insurance

Corporation. The Banking Act of 1935, 49 Stat. 684, Public Law 74-305, codified at 12 U.S.C. 228, terminated the temporary federal deposit insurance plan and inaugurated a permanent plan.

[7] In the fourth quarter of 2004, bank loans were 46.3 percent of all debt financing by businesses. However, that proportion can vary widely over the short term, as during the recession beginning in 2001 when bank credit shrank significantly. Statistics are derived from data in "Flow of Funds Accounts of the U.S.," Federal Reserve Bulletin, December 8, 2005, Table F.2, 10. As of midyear 2007, bank lending appeared to be contracting again; see "Corporate Credit: Where Have All the Checkbooks Gone?" Business Week, August 6, 2007, 34-35.

[8] Banks also generate enormous fee income from their consumer banking activities. For example, a recent survey concluded that $4.3 billion was paid in ATM fees in 2005. See "Fee for All," Business Week, December 26, 2005, 13 (quoting www. Bankrate.com).

[9] This has been most recently experienced in the recession beginning in 2001. See, for example, James Sagner, The Real World of Finance (2002), 89-90; "Who's Getting Hurt by the Loan Drought?" Business Week, May 20, 2002, 122-24; and Blanche Roberts and Dale Sorenson, "A Menu of New Strategies for the Credit-Starved Treasurer," AFP Exchange, September-October 2003, 38-42.

[10] Senate Report No. 91-1084, at 17 (1970).

[11] Eastman Kodak Company v. Image Technical Services, Inc. 504 U.S. 451 (1992).

[12] David S. Evans and Michael Salinger, "Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law," 22 Yale Journal on

Regulation 37, 89 (2005).

[13] "2004 Credit Access Survey: Linking Corporate Credit to the Awarding of other Financial Services," June 2004, at www.afponline.org/pub/pdf/2004_06_09_pr_creditaccess.pdf.

[14] Rob Blackwell, "Customer Survey Fuels Loan Tying Controversy," American Banker, March 19, 2003, 1.

[15] Bank Holding Company Act Amendments of 1970, Public Law No. 91-607, § 106(b), 84 Stat. 1760, 1766-67, codified as amended at 12 U.S.C. § 1972(1) (1988).

[16] Gage v. First Federal Savings & Loan Ass'n of Hutchinson, Kan., 717 F.Supp. 745 (1989).

[17] At 12 U.S.C. § 1972.

[18] S & N Equipment Co. v. Casa Grande Cotton Finance Co., 97 F.3d 337 (1996).

[19] Dannhausen v. First National Bank of Sturgeon Bay, 538 F. Supp. 551 (1982).

[20] Fredco of Wilmington, De., Ltd. V. Farmers Bank of State of Del., F. Supp. 995 (1980).

[21] This section is based on "Legality of Relationship Banking Under Bank Antitying Restrictions," Covington and Burling Memorandum (2003); at www. aba.com/NR/ rdonlyres/ EBCFA68E-ED93-11D4-AB70-00508B95258D/31619/ DuganRelationshipBankingMemo52804.pdf.

[22] At 12 U.S.C. § 1972(1)(A).

[23] Donald J. Mullineaux, "Tying and Subsidized Loans: A Doubtful Problem" (2003); at www.aba.com/NR/rdonlyres/EBCFA68E-ED93-11D4-AB70-00508B95258D/31616/ MullineauxTyingSubsidizedLoans52804.pdf.

[24] Mid-State Fertilizer Co. v. Exchange National Bank of Chicago, 693 F.Supp. 666 (1988), aff'd. 877 F.2d 1333.

[25] GAO, Additional Steps Needed to Ensure Effective Enforcement of Tying Prohibitions (2003); at www.gao.gov/new.items/d043.pdf.

[26] "Today's Credit Markets, Relationship Banking, and Tying," Office of the Comptroller of the Currency (2003).

[27] Letter from Alan Greenspan dated October 16, 2002; cited in the Office of the Comptroller of the Currency report in footnote 26, 2.

[28] Federal Register, August 29, 2003, 52024-52035; 52033-52035; at a257. g.akamaitech.net/ 7/257/2422/14mar20010800/edocket.access.gpo.gov/2003/pdf/03-22091.pdf.

[29] It should be noted that the author has attended numerous meetings with clients and bankers over the past twenty years where such comments were made.

[30] At 12 U.S.C. § 1841 et seq.

[31] At 12 U.S.C. § 1972 (2)(F).

[32] At 12 U.S.C. § 1972 (2)(F)(ix).

[33] At 12 U.S.C. § 1976.

[34] For a law journal review of this issue, see Christian A. Johnson, "Holding Credit Hostage for Underwriting Ransom: Rethinking Bank Antitying Rules," 64 University of Pittsburgh Law Review 157 (2002).

[35] As promulgated in the Federal Reserve's Regulation Q; see 12 Code of Federal Regulations Part 217. For a Hollywood version of a banking panic (in a savings and loan association), see It's a Wonderful Life (Frank Capra, director, 1946). Naturally, hero George Bailey (Jimmy Stewart) saves the day!

[36] For example, H.R. 758, the Business Checking Freedom Act of 2003, similar to H.R. 1009 (2002); H.R. 924 was an equivalent bill proposed in the 1999–2000 congressional term. The Congressional Budget Office had previously estimated that paying interest on reserves held at Federal Reserve banks would reduce the profits of the Federal Reserve by an average of $100 million a year. Since the Federal Reserve remits its profits to the U.S. Treasury, any reduction in Federal Reserve profits would translate into a reduction in federal revenue.

[37] Historical data on Federal Reserve funds are available at www.ny.frb.org/markets/statistics/dlyrates/fedrate.html.

[38] Public Law 89-356, § 2, 80 Stat. 10, 12 U.S.C. 1828(c).

[39] For specific HHI criteria as applied to banking, see Table 10, "Merger Guidelines of the U.S. Department of Justice," in Kenneth Spong, Banking Regulation, Federal Reserve Bank of Kansas City (5th edition, 2000), 170.

[40] For a discussion of this merger, see Brian W. Smith and Laura R. Biddle, "Is the Bank Merger Regulator Review Process Ripe for Change?" Bank Accounting & Finance, April/May 2005, 9-14, at www.lw.com/resource/Publications/_pdf/pub1336_1.pdf.

[41] "Fed OKs Bank of America Merger with MBNA," December 15, 2005; at cnnfn.cnn.com/2005/12/15/news/fortune500/boa_mbna.

[42] Many transactions occur today through the ACH (automated clearinghouse) or by federal wire. These systems allow companies to send files of transaction data through banks and on to recipients, entirely replacing paper disbursements. For an explanation of these and other products, see Michele Allman-Ward and James Sagner, Essentials of Managing Corporate Cash (2003).

[43] The Check 21 initiative of the Federal Reserve (effective October 28, 2004) provides a means for customers to send and receive image files through substitute checks read at a place of business by an image reader. This new technology and the supporting regulation significantly reduce the need to deposit physical checks at a bank. Enacted in the Check 21 Act of October 28, 2003, 117 Stat. 1177, Public Law 108-100, § 1(a), 12 USCS § § 5001 et seq.

[44] See Barnard Wysocki, Jr., "Greenspan Opposes Bank Loophole," Wall Street Journal, January 26, 2006, A3 (discussing outgoing Federal Reserve Chairman Alan Greenspan's concerns over the expansion of industrial banks). Wal-Mart spent considerable effort in developing an industrial bank proposal before abandoning the attempt; see Eric Dash, "Wal-Mart Abandons Bank Plans," New York Times, March 17, 2007, C1, C8. Opposition from community bankers and other parties became overwhelming and led to the threat of new congressional legislation. Despite this development, such other nonfinancial companies as Target and General Motors have

received approval for industrial banking operations.

[45] Securitization involves the packaging of similar financial assets, such as mortgage loans, and creating a tradeable security. Financial institutions and businesses of all kinds use securitization to immediately realize the value of a cash-producing asset.

[46] Michael Schroeder, "Banks Might Widen Real-Estate Role," Wall Street Journal, January 9, 2006, A3-A4, referring to a PNC Financial project to build a $170 million complex including office, hotel, and residential space and a Bank of America plan to build a $60 million hotel. However, the Office of the Comptroller of the Currency may be backing away from blanket approval of real estate projects for banks; see "Comptroller Dugan Issues Statement Regarding Real Estate Rulings," January 11, 2006, at www.occ.gov/toolkit/newsrelease.aspx?Doc=9N8ZI1XU.xml.

[47] Nearly 3,000 commercial banks required FDIC support or failed during those fifteen years; summarized from data available at www2.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=1980&EndYear=1995&State=2.

[48] For a brief discussion of these suggestions, see Spong, reference in note 39, 258-60.

[49] Book value is the sum of common stock, paid-in capital, and retained earnings, divided by shares outstanding. "Outlook Scoreboard 2005," Business Week, December 26, 2005, 130-53.

[50] The four highest total return industries are homebuilders, medical products and equipment, securities, and diversified financials. "Fortune 500" issue, Fortune, 2005, F-29.

CHAPTER 4: FINANCIAL SERVICES

And it is great
To do that thing that ends all other deeds,
Which shackles accidents, and bolts up change.
William Shakespeare (1564–1616), Antony and Cleopatra

The financial services industries include commercial banking and other bank-like institutions (such as savings banks and credit unions); securities firms (often referred to as investment bankers); insurance companies (generally categorized as life and health, and property and casualty); and finance companies. Chapter 3 reviewed commercial banking in detail; this chapter discusses the business regulation of financial service industries with a focus more on the securities markets and insurance.

EARLY AMERICAN EXPERIMENTS WITH FINANCIAL SERVICES

Alexander Hamilton's reports to Congress (see Chapter 1) included the first policy statement on financial services, specifically with regard to the creation of a national bank.[1] However, the national distrust of a strong federal government extended to the financial sector and directly affected the fortunes of the first national banks and, later, the securities markets.

THE BANKS OF THE UNITED STATES

The idea of a national or central bank (like the Bank of England), as proposed by Hamilton, was an early litmus test for the country. The

Revolutionary War had left the new nation deeply in debt, with some states facing bankruptcy. The U.S. government had not issued currency, so state banks issued their own currency whose soundness could range from impeccable to worthless. There were over 700 state banks, some of which carried sufficient specie to meet any demands. But others, issuing currency far exceeding their specie deposits, were forced into insolvency when an unexpected number of depositors demanded gold or silver for their notes, leaving depositors with worthless money.

In 1791 the Bank of the United States (1BkUS) received a charter from Congress, signed by President Washington. Agrarian interests opposed the bank, fearing that it would favor commercial and industrial interests over their own and that the use of paper currency would be promoted at the expense of gold and silver specie.[2] Foreign ownership was another concern; by the time the charter was up for renewal, foreigners owned about 70 percent of its stock.[3] Then Secretary of State Thomas Jefferson claimed that the bank was unconstitutional because it was an unauthorized extension of federal power. Hamilton argued that because Congress had the power to tax, borrow money, and regulate both interstate and foreign commerce, it would certainly be empowered to charter a corporation to enable it to carry out those powers. Hamilton's arguments prevailed, and the 1BkUS carried out its duties with great success.[4]

The 1BkUS had both public and private functions. Its primary public function was to control the money supply by regulating the amount of notes state banks could issue and by transferring reserves to different parts of the country. It was also the depository of the Treasury's funds that would otherwise go to politically favored private banks. It not only competed with state banks but also set the rules for those banks. The 1BkUS was extremely profitable, earning most of its income through loans to governments and private businesses. By 1811, the 1BkUS had circulation of about $5 million in

paper currency, equivalent to about 20 percent of the nation's money supply. This currency and credit activity were at the expense of state banks, which led agrarian interests and those who were opposed to a strong central government to defeat the application for charter renewal.[5]

AFTERMATH AND THE SECOND BANK OF THE UNITED STATES

The 1BkUS narrowly failed to win charter renewal largely because of considerations of "unfair" competition with state chartered banks. However, reliance on a state banking system works only when three conditions hold:

1. The U.S. experiences relatively peaceful relations with other nations, without the need to make massive expenditures on defense and to overcome the loss of tariff revenue generated through international trade.
2. State banks conduct their business in a prudent manner, with conservative lending supported by adequate collateral.
3. No political or economic panic occurs to affect the stability of the financial system.

No longer accountable to a central bank or regulated by the government, state banks went on a spree of printing bank notes. State banks were chartered indiscriminately. J.K. Galbraith writes: "Every location large enough to have a church, a tavern or a blacksmith shop was now deemed a suitable place for setting up a bank."[6] Not only did these banks issue notes, but so did barbers and bartenders and just about anyone who wanted to get into the act. Exacerbated by the War of 1812 with Great Britain, this irresponsibility caused rapid inflation, with prices rising over 13 percent per year, and led to general economic uncertainty.

The new or Second Bank of the U.S. (2BkUS) opened in 1817, with its primary mission to limit the amount of paper money issued by state banks against holdings of specie. The bank's charter accorded it the power to act as the federal government's sole fiscal institution by accepting deposits from tax collections and handling interstate fund transfers. Despite these responsibilities, the bank was not owned by the U.S. government; instead, it was a private bank answerable to its board of directors and some 4,000 stockholders.

The 2BkUS immediately encountered global changes that were largely beyond its ability to contain. A significant disruption resulted from the aftermath of the Battle of Waterloo and the final defeat of Napoleon in 1815, which allowed British companies to dump previously unsold goods on the American market. In addition, agricultural prices rose sharply, reflecting the requirement for food exports by European countries facing crop failures as well as an inexhaustible demand for cotton. However, the European situation began to stabilize by 1818, and with increasing competition from Indian cotton, the post-1815 speculation ended in a ruinous economic collapse.[7]

The 2BkUS aggravated the situation by increasing its issuance of paper currency and by encouraging imprudent business investments. Forced to reverse policy, the contraction of the money supply and the calling in of loans drove the recession of 1819-1820 into a prolonged depression, resulting in failures of individuals, businesses, and state banks. As Sean Wilentz notes, this economic disaster affected every region of the U.S., including farmers, small-town merchants, and the industrial cities of the East and Midwest. The result was a severe economic contraction that did not begin to lift until 1822.[8]

The election of Andrew Jackson in 1828 brought an antibank president into office who saw and condemned economic rule by an elitist few who could exert undue influence over national policy. In addition, Jackson believed that the Constitution did not permit Congress to create a national bank and that it had asserted powers not provided by the Founding Fathers. He therefore decided

that a rechartering, due for consideration in 1836, should be prevented.[9] As a result, the U.S. would have no central bank until the Federal Reserve System was established in 1913.

INDUSTRIALIZATION AND THE CORPORATION

Although Hamilton's national bank idea was abandoned during the Jackson Administration, other elements led to significant structural innovations in the American financial system. A major initiative was the refunding of the American Revolutionary War debt, referred to during the Congressional debates as "assumption." Hamilton advocated the consolidation and taking over (or assumption) of debts incurred by the states and still outstanding as a de facto obligation of the national government.[10]

This was opposed by those states – like Virginia – that had already repaid much or all of their debt and saw the plan as a subsidy to the remaining debtor states. With Hamilton's entire economic program at risk, the issue was resolved at a famous dinner in the Summer of 1790, at which a compromise was struck among the parties representing the conflicting issues of the day: assumption and the permanent location of the capital city.[11] The new federal bonds that resulted from the passage of the assumption plan were known as "Hamilton 6s" because of the interest rate that was paid. Proceeds were primarily used to retire the outstanding debt obligations of the states.

THE ORIGINS OF THE SECURITIES MARKETS

Because the Hamilton 6s were redeemable at par, they became extremely popular investments and regularly traded above par, that is, above the value of the bond at maturity.[12] Confidence in the U.S. economy and the restructuring of the economy resulted in active trading in the Hamilton 6s and in state bonds, leading to the decision in 1792 to organize an exchange that would eventually become the New York Stock Exchange (NYSE).[13] Other exchanges developed in major industrial cities on the East Coast, including Boston, Philadelphia, and Baltimore. The creation of these markets allowed businesses to raise new equity capital, today called "primary" market operations, and permitted investors to buy and sell securities at fair prices, known as the "secondary" market.

The resulting liquidity encouraged foreign investors to participate in these markets, with a significant portion of American securities eventually owned by Europeans who perceived the opportunity for greater returns and growth in the new world. These innovations in the capital markets were a fortuitous development at a time when the U.S. was experimenting with a new form of business organization – the corporation – and with the financial requirements of the Industrial Age.

THE CORPORATE FORM OF OWNERSHIP

The corporation had been used for at least two centuries by European nations for specific national purposes. Two leading British examples of such government charters were the East India Company created in 1600 with a monopoly on trade with India and the Hudson Bay Company created in 1670 that controlled the fur trade throughout much of British-controlled North America.[14] The American innovation allowed state governments to charter corporations based merely on the request of investors who desired to both limit their liability and sell enough shares to attain the vast amounts of capital required by industrial companies.

These requirements were accompanied by several essential characteristics of the corporate form:[15]

- Permanence, in that the business would continue despite the retirement or death of a principal (unlike the sole proprietorship or partnership, which would end at the loss of an owner) or the cessation of activities (as in the earlier joint-stock companies).

- Legal shelter, in that state legislatures and courts created a unique body of law for governance as protected by the finding of the Supreme Court in the Dartmouth College case.[16]

- Centralized management, permitting the accumulation of the appropriate expertise to operate a large business enterprise.

RAILROADS AND INDUSTRIALIZATION

Although the republican distrust of business continued, state legislatures and courts allowed corporations considerable latitude to finance and expand their activities. The principal beneficiaries were the railroads, given the enormous capital amounts required to acquire rights-of-way, hire managers and laborers, construct tracks and stations, and purchase rolling stock.[17] As U.S. migration headed westward, rivers were inadequate to allow easy movement of agricultural and manufactured goods to and from the East Coast.[18] The early railroads proved to be economic boons to the communities they served, which increased the frenzy of railroad construction. Prior to the Civil War there were over $1 billion of securities issued; by 1870 that amount had reached $2.5 billion, and by 1890 the amount was $10 billion.

U.S. and European bondholders were attracted, for both the safety of their principal and reasonable interest rate returns. The preference was for debt instead of stock ownership, for a railroad in default could be reorganized and bondholder capital recovered.[19] The inevitable result was rapid growth in track mileage, in industries that supplied the railroads and that supplied manufactured goods to the U.S. and the world, and in population movement into territories that eventually became new states.

EXPERIMENTS IN SELF-REGULATION

Given the sums being invested in the U.S. after the end of the Civil War, the twenty-first-century observer might well wonder how the federal government ignored this ripe opportunity for regulation, particularly given the recurrent abuses and swindles that occurred in the securities industry. Scoundrels like Jay Gould and Jim Fisk could single-handedly interrupt the smooth functioning of the securities markets and the economy.[20] Remedies were eventually developed but by the private sector rather than through Congressional action, which was considerably more palatable to a country still clinging to a republican ethos of individuality and small government.

THE INVESTMENT BANKER AS "REGULATOR"

The first solution to the regulation problem largely resulted from a contentious battle for control of the Albany and Susquehanna railroad in 1869.[21] A hot dispute between Cornelius Vanderbilt and his associates against Jay Gould and his allies resulted in the election of two separate boards, forcing the issue into state court. J.P. Morgan represented Vanderbilt in his capacity as chairman of the New York Central railroad and arranged to have the case tried in the friendly venue of Delhi, New York, where Vanderbilt prevailed. The Court of Appeals then reversed this decision except for the critical issue of control.[22] The resulting public outcry demanded reform; a leading magazine of the time, Harper's Weekly, insisted that:

> If scenes of anarchy are to be avoided, if New York is to retain its preeminence as the commercial metropolis of the country, if foreign capital is to be retained here, something must be done to prevent, in the future, the unseemly abuses of power into which certain of our state judges have been betrayed in the past.[23]

There were continuing issues concerning the control of this railroad, leading to various disputed shareholder elections for board members, further lawsuits with conflicting outcomes depending on the jurisdiction of the court, and inaction by corrupt state legislatures.[24] The result was the demand by J.P. Morgan for board membership for a senior member of his firm (J.P. Morgan & Co.) as a condition for his willingness to act as the client's investment banker. The role of this party would be to assure the security of investors by requiring disclosure of financial and business activity. Other investment bankers followed this precedent, and within a relatively short time, the practice became institutionalized.[25]

THE STOCK EXCHANGE AS "REGULATOR"

The dual requirements for share liquidity at a fair price and the ability to raise debt and equity capital have justified the uniquely capitalistic concept of exchanges to trade securities for more than three centuries.[26] At the time of the founding of the U.S., the leading industrial country was Great Britain and therefore the principal financial market was in London. The NYSE and similar American markets based their structures and form of organization on the London Stock Exchange (LSE) and those of major European cities but chose to develop several important differences in their model of administration:[27]

- The NYSE was a closed system, requiring aspiring participants to buy their seats (or evidence of membership) from current owners.[28] In contrast, the LSE has been an open system, with five times the number of members as the NYSE in the years before World War I. The U.S. model has allowed the growth of a limited number of large, diversified financial services companies that dominated investment banking through much of the twentieth century, particularly as the American rules allowed these firms to raise capital from external sources.

- The NYSE had fixed brokerage commissions until 1975, raising transaction costs and dissuading trades in low-priced securities.[29] This decision drove many small companies to other exchanges (like the American Stock Exchange and the Over-the-Counter/NASDAQ Market) while reinforcing the image of the NYSE as a safe and somewhat elitist trading exchange. In contrast, the LSE permitted variable commissions throughout its history.

- The NYSE mandated disclosure rules for members to end the manipulation and other unethical practices of unscrupulous scoundrels. The LSE had no such requirements, and the smaller investor could well question the honesty and integrity of the market.

The effect of this self-regulatory administrative approach worked reasonably well into the early twentieth century. However, there were very severe recessions and business failures caused by honest but uninformed speculation and by dishonest stock promotion, particularly in securities traded on exchanges other than the NYSE. The panic of 1907 which was finally abated by the actions of a considerably older J.P. Morgan was the last time Congress was willing to allow self-management;[30] by 1913 the Federal Reserve Act

became law to finally reestablish an American central bank.[31]

FEDERAL SECURITIES REGULATION

The crash of the stock market in 1929 ended the era of self-regulation that the securities markets had enjoyed for 135 years. In the landslide election of 1932,[32] Franklin Roosevelt campaigned on various issues related to what had become known as the Great Depression, including the failures of the securities markets in general and the collapse of the Samuel Insull electric utility empire in particular.[33] The Democratic Party promoted a platform with "Three R's – relief, recovery, and reform," and the candidate coined the term "New Deal" when he stated: "I pledge you, I pledge myself, to a new deal for the American people."[34]

Roosevelt inherited an economic catastrophe that had been brewing for several years, involving agricultural prices that had been falling since 1927, unrealistically low 10 percent margin requirements for stock purchases,[35] and overinvestment in industrial capacity.[36] However, much of the spotlight focused on financial industry corruption and self-dealing.[37] The regulation that eventually resulted from the Insull situation and other scandals involved a series of laws passed in the first two Roosevelt Administrations.

SECURITIES ACT OF 1933

The objectives of the Securities Act of 1933 were to require that investors receive financial and other significant information concerning securities being offered for public sale; and to prohibit deceit, misrepresentations, and other fraud in the sale of securities.[38] Evidence developed during the Senate's Pecora hearings led Congress to conclude that information on publicly traded securities was either inadequate or, in some instances, deceptive and that securities offered for sale should provide potential investors with sufficient information about the issuer to make an informed decision. Supreme Court Justice Louis Brandeis coined the phrase "sunlight is the best disinfectant,"[39] which is part of the philosophy underlying the 1933 act.

GLASS-STEAGALL ACT OF 1933

The Glass-Steagall Act separated investment and commercial banking activities[40] to prevent commercial banks from holding securities that had been underwritten and "parked" in inventory or held for purposes of speculation.[41] Unsound loans had been granted to companies in which the bank had invested, and clients of the bank were encouraged to invest in those same stocks. The Pecora hearings elicited some evidence of "improper banking activity," and this was considered at the time to be a principal factor in the stock market crash. Cooler heads and objective analysis later showed that the actions of these firms were a minor component of the total situation, but Congress found a convenient scapegoat for the economic costs and loss of investor confidence.[42]

Securities firms were forced to choose commercial or investment banking as their principal line of business, and if they selected commercial banking, they could retain only 10 percent of their total income from securities. An exception allowed commercial banks to underwrite government-issued bonds. J.P. Morgan[43] and other large banking and securities operations were forced to sever their investment banking services and, as a result, had to forgo an important source of their income.

SECURITIES EXCHANGE ACT OF 1934

The Securities and Exchange Commission (SEC) was created by Congress in the Securities Exchange Act of 1934 with broad authority over

all aspects of the securities industry.[44] Responsibilities include the registration, regulation, and oversight of all participants in the securities industry, including transfer agents, clearing and settlement, and trading exchanges.[45] An important function of the SEC is to determine that adequate publication of relevant data has been provided to investors through the mechanism of a registration statement called a prospectus. The act also specifies and prohibits certain types of conduct in the markets considered detrimental to fair dealings and full disclosure, and disciplinary power is provided to oversee regulated firms and individuals.[46]

THE INVESTMENT COMPANY ACTS OF 1940

Further legislation – often grouped together as the Investment Company Acts – regulates organizations that primarily invest in securities of other companies (such as mutual funds) and firms that are engaged as investment advisors.[47] Investors buy shares in a mutual fund which, in turn, invests in stocks, bonds, and other securities. An investment advisor makes day-to-day decisions about which portfolio securities the mutual fund should buy or sell. Congress wanted to address perceived abuses in the mutual fund industry and to minimize conflicts of interest that could arise in the operation of these companies. The remedies are similar to those provided by the 1934 act, including mandatory disclosure of a fund's structure, operations, financial condition, and investment policies.

REGULATION OF THE INSURANCE INDUSTRY

Following the republican tradition, regulation of the insurance industry has been the responsibility of the states, although specific products with investment features (such as variable annuities) are also subject to the rules of the SEC. The historical development of insurance was largely based on what is known today as property and casualty lines. Insurance underwriting began with the recognition by colonial businessmen and homeowners that marine risks arise from ocean (and later inland waterway) shipping and construction risks arise from the threat of fire to wood, the predominant material used in construction. The participation of such luminaries as Benjamin Franklin brought recognition to the industry and the very real economic function provided by property and later by life insurance.[48]

EARLY TWENTIETH-CENTURY CONCERNS

As with the securities industry, scandals erupted periodically, and critics responded with demands for federal regulation. A leading example was the ostentatious spending by James Hyde, president of the Equitable Life Assurance Company, causing the New York Insurance Superintendent to investigate the company and the entire industry. The Armstrong Committee concluded that insurance companies were placing reserves established to pay claims at unreasonable risk by speculating in stocks.[49] Various constraints were then implemented to protect policyholders and stockholders, including restrictions on common stock investing and prohibitions on securities underwriting. These actions hampered the ability of investment bankers to raise capital and may have exacerbated the post–World War I recession. The insurance companies initially opted for federal regulation to avoid sometimes harsh and conflicting state regulation but eventually preferred oversight by the states.[50]

This more conservative investment philosophy mandated by insurance regulators actually saved much of the industry during the Depression, while commercial banks and securities firms experienced a much higher rate of failure. Hundreds of insurers were forced to borrow from the Reconstruction

Finance Corporation,[51] and the value of insurance assets was negatively affected by the low returns on debt securities and the surrender of policies by insureds unable to afford their coverage. However, Congress saw much worse distress in other financial services companies and proceeded to legislate and regulate these problems while leaving insurers to the states.

Just prior to World War II, the Temporary National Economic Committee (TNEC) rejected an SEC proposal to create a federal agency to regulate insurance companies after vigorous opposition from the industry.[52] The Supreme Court's decision in U.S. v. SouthEastern Underwriters Association[53] then threatened the industry, holding that insurance was subject to federal antitrust. Congress responded by enacting the McCarran-Ferguson Act,[54] which granted insurance companies immunity from the antitrust laws to the extent that they were regulated by state insurance laws.

DEVELOPMENTS AFTER WORLD WAR II

The McCarran-Ferguson Act largely excluded any federal regulation until insurance companies began offering variable annuities in 1952.[55] The SEC claimed that variable annuities were securities subject to regulation under the federal securities laws because returns were based on the investment of the annuitants' premium payments in securities. The Supreme Court found for the SEC in two leading cases,[56] resulting in the dual regulation of insurance companies selling variable annuity contracts and the requirement to separate reserves for such products from reserves for more traditional insurance.[57] The loss of business to other financial services companies by the beginning of the 1990s forced industry restructuring through demutualization,[58] company mergers, and expansion of product offerings.

There have been occasional attempts to switch to some form of federal insurance regulation.[59] The various problems experienced by the industry include low profitability,[60] the failure of some smaller and the distress of some larger companies,[61] lawsuits over abusive sales practices,[62] and inroads into the traditional insurance market by direct writers (e.g., GEICO, AARP through the Hartford Insurance Group, USAA) and by other financial services companies (e.g., Merrill Lynch Life Insurance Company, General Electric Capital Assurance Company).

THE U.S. FUNCTIONAL APPROACH TO FINANCIAL REGULATION

It was recognized fairly soon after the passage of the Glass-Steagall Act that Congress had perhaps overreacted to the bad behavior of a few scoundrels in the years before the Crash of 1929. However, nearly seventy years passed before there was consensus to impose less onerous restrictions on commercial and investment banks.

THE GRAMM-LEACH-BLILEY ACT

The Gramm-Leach-Bliley Act of 1999 was the product of years of lobbying by the financial services industries and successful primarily because the federal government perceived the need to retain and enhance the competitiveness of U.S. financial institutions in the global economy.[63] This act allows any bank, securities firm, insurance company, or finance company to conduct business activities in any area of financial services without restriction.

However, Gramm-Leach-Bliley is based on “functional regulation,” continuing the established scheme for the various activities of a financial services company. For example, if a financial company engages in banking, insurance, and securities, each business would be separately regulated – by the Comptroller of the Currency, by state insurance commissions, and by the SEC,

respectively. However, it is apparent that the different areas of the financial services industry have been gradually intermingling over the last quarter of a century and that this functional separation of regulation does not address current business practices.

Computers and telecommunications are reducing the importance of the traditional intermediation function. The Internet is turning financial services into a commodity that can be bought online, just like a book or a DVD. Utilizing technology to sell new financial products to existing customers may also be less expensive than acquiring a bricks-and-mortar entity. Depositors and borrowers can now bypass banks in favor of direct access to the capital markets to obtain higher returns not subject to the transaction costs imposed by an intermediary.

HOW DO OTHER COUNTRIES REGULATE FINANCIAL SERVICES?

In contrast to the U.S. model of functional regulation, the United Kingdom and Japan use a consolidated regulator for financial services; see further discussion in Chapter 7. The single regulator approach permits financial regulation from the larger perspective of the strategic objectives and decisions of a financial services organization, rather than of specific product lines and operations. There is an interesting aspect to the U.K. model which is reminiscent of the early U.S. attitude: the culture of avoiding governmental interference in business.[64] British regulators have learned from long experience that, while there will always be scandals and failures, each should be dealt with accordingly and with remedies specific to the circumstances. This is in sharp contrast to the current American approach to business regulation: that fraud and the misappropriation of company funds can be prevented only by severe civil and criminal penalties.

In contrast, Japan has a regulatory culture of intervention and economic management. The Ministry of Finance largely controlled the economy with some success in its early stages; Japan even threatened the

U.S. competitively until about 1990. That model, largely the responsibility of the Ministry of Finance, was successful during the growth period of the Japanese economy, but failed as the economy became more complex and as centralized decision-making prevented a market economy from functioning efficiently. The creation of a Japanese consolidated regulator appeared to search for market solutions to financial problems. However, that agency still appears to cling to the culture of managing the economy by supporting large banks and resisting foreign competition. Consequently, the Japanese model does not seem to be as suitable for a developed economy.

WHAT THE U.S. SHOULD DO

Because there will certainly be problems with and political opposition to a single regulator, the organizational solution may be to split regulation into its logical constituencies:[65]

- For institutional investors, management of financial services businesses in terms of such risk categories as:
- Insurance risk for the safety of customer funds that are on deposit with a financial services firm. This would include the segregation of customer funds and administration of account insurance (like the FDIC discussed in Chapter 3).
- Business risk to protect the integrity of the intermediation process used by all financial services companies. This would include assurance that adequate collateral exists for loans, that appropriate due diligence has occurred in deciding whether to establish and continue relationships with customers, and that necessary

documentation exists to support financial transactions.

- Systemic risk for the security of the financial system. This would involve uniform capital requirements, payment system regulation, and the monitoring of financial system liquidity.
- For individual investors, depositors, and consumers: protection for those who are too weak, uninformed, and scattered to defend themselves. The securities industry has long recognized that institutions and other sophisticated market participants do not need the same regulatory protections as unsophisticated investors.[66] Financial services for retail customers would be subject to regulation and the protections afforded such investors, policyholders, and depositors across product lines. This includes prevention of deceptive sales practices and prosecution of “churning” of securities and of fraudulent profit claims.

The financial services industry is becoming a global business as banks, securities firms, and insurance companies seek clients in every country where there is a profit opportunity. American firms must compete with global firms that cross-sell financial products and are subject to much lighter regulation.[67] The confusion, complexity, and costs associated with multiple regulators will certainly place U.S. financial institutions at a severe competitive disadvantage with European and Asian firms that operate under a single regulatory umbrella.

ENDNOTES FOR CHAPTER 4

(Endnotes)

[1] "Report on a National Bank" (December 13, 1790), in Alexander Hamilton: Writings 575-612 (Joanne B. Freeman, ed., 2001).

[2] David S. Kidwell and Richard Peterson, Financial Institutions, Markets, and Money 54 (5th edition, 1993).

[3] William F. Hixson, Triumph of the Bankers: Money and Banking in the Eighteenth and Nineteenth Centuries 115 (1993).

[4] Gerald T. Dunne, Monetary Decisions of the Supreme Court 17-19 (1960).

[5] Edward L. Symons, Jr., and James J. White, Banking Law 12 (2nd edition, 1984).

[6] John Kenneth Galbraith, Money: Whence It Came, Where It Went 58 (1995).

[7] For a historical perspective, see Sean Willentz, The Rise of American Democracy: Jefferson to Lincoln 202-17 (2005).

[8] Ibid., discussed in Chapter 6.

[9] Ibid., discussed throughout Chapter 12.

[10] "Report on the Public Credit" (January 9, 1790), in Alexander Hamilton: Writings 531-74 (Joanne B. Freeman, ed., 2001).

[11] This dinner – if events occurred in the manner described by various historians

– was arguably the most important meal held in the history of the nation. It was hosted by Thomas Jefferson, then Secretary of State under Washington and later the third U.S. president. Attendees included Hamilton and James Madison, then a congressman and later the fourth U.S. president. For an account of the proceedings, see Joseph J. Ellis, "The Dinner," Founding Brothers: The Revolutionary Generation, 48-80 (2000).

[12] Bonds that trade above par in a stable interest rate environment are valued largely on the perceived strength or creditworthiness of the issuer. As noted by Professor Gordon, by 1794 the U.S. had the highest credit rating among issues trading in Europe. John Steele Gordon, Hamilton's Blessing: The Extraordinary Life and Times of Our National Debt, 38-39 (1997).

[13] A formal organization was created in 1817 called the New York Stock & Exchange Board. This name was shortened to the New York Stock Exchange (NYSE) in 1863.

[14] For a historical perspective, see John Keay, The Honourable Company: A History of the English East India Company (1991); and George Bryce, Remarkable History of the Hudson's Bay Company (2005).

[15] For a succinct review of the development of the corporate form of business organization, see Morton Keller, "The Making of the Modern Corporation," 27 The Wilson Quarterly 58-69 (1997). For a legal analysis of the early history, see Douglas Arner, "Development of the American Law of Corporations to 1832," 55 Southern Methodist University Law Review 23 (2002).

[16] 17 U.S. 518 (4 Wheat.) (1819). The court cited the Contract Clause of the Constitution (article 1, 10, cl. 1) in establishing that the State of New Hampshire could not interfere in the activities of the college. According to Chief Justice John

Marshall, corporate property is identical to private property.

[17] The typical manufacturing facility required less than $1 million to construct and equip; in contrast, railroads were usually capitalized at amounts greater than $15 million. Railroads were America's largest businesses by the 1860s; the Pennsylvania Railroad was the largest corporation in world, with over $60 million of invested capital. See Jean Strouse, Morgan: American Financier 131 (1999).

[18] In fact, no major river flows east-to-west in the U.S. (except for a few largely unnavigable rivers in the West), severely restricting the growth of the country until the emergence of the railroads.

[19] Strouse, reference in note 17, at 133.

[20] See, for example, Kenneth D. Ackerman, The Gold Ring: Jim Fisk, Jay Gould, and Black Friday, 1869 (1990).

[21] For a description of the issues, see John Steele Gordon, The Scarlet Woman of Wall Street (1988). For a legal analysis, see John C. Coffee, Jr., "The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control," 111 Yale Law Journal 1 (2001).

[22] People v. Albany & Susquehanna Railroad Co., 7 Abb. Pr. (N.S.) 265, 38 How. Pr. 228, 1 Lans. 308, 55 Barb. 344 (N.Y. Sup. Ct. 1869). The court upheld the Vanderbilt/Morgan-backed board of directors, rejecting the election of the Fisk/Gould-backed slate on the grounds of fraud. After an appeal overturned this decision, the Court of Appeals sustained the trial court's finding of fraudulent conduct by the Fisk/Gould faction. People v. Albany & Susquehanna R.R. Co., 57 N.Y. 161 (1874).

[23] Issue of February 12, 1870, cited in Gordon, reference in note 21, at 252-53.

[24] These matters are discussed in Christian C. Day, "Partner to Plutocrat: The Separation of Ownership from Management in Emerging Capital Markets – 19th Century Industrial America," 58 University of Miami Law Review 525, 560-64 (2004).

[25] Gordon, reference in note 21, at 153.

[26] The early ownership of stocks was limited and sales were transacted directly between buyers and sellers. There is evidence of stockbrokers in England as early as the late seventeenth century. For a historical review, see Edward Stringham, "The Emergence of the London Stock Exchange as a Self-Policing Club," 17 Journal of Private Enterprise 1 (2002).

[27] The following section is based on the analysis in Coffee, reference in note 21, at 32-37.

[28] Seats on the NYSE represented both an equity interest and the right to access the trading facilities. According to the NYSE, member seat sales officially ended in 2005, in anticipation of plans to convert to a public ownership following a merger with Archipelago Holdings. In 2005, NYSE seat prices reached historic highs, quadrupling from a low of $975,000 in January to reach an all-time high of $4 million in early December. The final merger resulted in the NYSE's 1,366 seat holders becoming shareholders in the newly formed public corporation, NYSE Group.

[29] The NYSE and other stock exchanges converted to a negotiated commission system because of the adoption of Securities and Exchange Commission Rule 19b-3, which requires the elimination of fixed commission rates for public customers of their members effective May 1, 1975. Exchange Act Release No. 11203 (January

23, 1975). Rule 19b-3 was codified in certain respects by Section 6(e)(1) of the Exchange Act, enacted as part of the Securities Acts Amendments of 1975, Public Law 94-29, 89 Stat. 97, 107-8, codified at 15 U.S.C. 78bb(e).

[30] For an explanation of the causes of the 1907 panic and Morgan's role, see Ron Chernow, The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance (1990), Chapters 7 and 8.

[31] The act provides for the establishment of federal reserve banks to manage the money supply, to afford means of rediscounting loans made by commercial banks, to establish a more effective supervision of banking in the U.S., and for other purposes; dispersed throughout 12 U.S.C.; Chapter 6, 38 Stat. 251.

[32] The Roosevelt-Landon ticket won more than 57 percent of the popular vote, carried the Electoral College by 472 to 59, and lost only five states.

[33] For a review of the history of Insull and an interesting contrast to the present-day Enron debacle, see Richard D. Cudahy and William D. Henderson, "From Insull to Enron: Corporate (Re)regulation after the Rise and Fall of Two Energy Icons," 26 Energy Law Journal 35 (2005).

[34] Statement made while accepting the 1932 Democratic presidential nomination, July 2, 1932, Chicago, Illinois.

[35] Margin is the amount of cash required to purchase shares. The remaining amount is borrowed from the securities firm that executes the transaction, with the shares used as collateral for the loan. If an owner is unable to meet margin requirements as stock prices fall, then the securities firm sells the shares to cover the debt. In the 1929 crash, prices fell so fast and so broadly that there were periods when margin accounts

could not be liquidated at any price. The current margin amount is 50 percent as administered by the Federal Reserve. See Regulation U; 12 CFR 221; available at www.federalreserve.gov/regulations/cg/regucg.htm.

[36] A useful history of the causes and results of the 1929 stock market crash is John K. Galbraith, The Great Crash 1929 (1979).

[37] The U.S. Senate conducted an investigation on stock exchange practices in 1931, "The Stock Exchange Practices Hearings of the Senate Committee on Banking and Currency," more commonly known as the Pecora hearings (after the Senate's chief counsel). See Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance, 1-38 (3rd edition, 2003).

[38] 48 Stat. 74, codified at 15 U.S.C. 77a-77aa.

[39] Louis Brandeis, Other People's Money (1933), 62.

[40] Also known as the Banking Act of 1933, Public Law 73-66, 48 Stat. 162 (1933).

[41] An important function of an underwriter is to guarantee a corporate issuer that its securities will be sold at a specified price. The underwriter assumes all of the risk of distributing the securities and is forced to put unsold securities in its own inventory if the issue is not successful.

[42] See George J. Benston, "The Origins and Justification for the Glass-Steagall Act," in Universal Banking: Financial System Design Reconsidered (1996), 31-69; and George J. Benston, The Separation of Commercial and Investment Banking (1990).

[43] The successor firms from the J.P. Morgan split are seen today as the commercial

bank JPMorgan Chase and the investment bank Morgan Stanley.

[44] 48 Stat. 881, codified at 15 U.S.C. 78a et seq.

[45] Transfer agents (usually commercial banks) are used to keep records on individuals and entities that own a publicly traded company's securities. Clearing and settlement involve the receipt in good form of a security that has been traded (including book-entry or the actual certificate), and the payment on the settlement date to the seller from funds provided by the buyer.

[46] It is beyond the scope of this chapter to delve into the workings of the SEC or of such requirements of issuers of securities as the prospectus and of securities firms as broker licensing. For a discussion of such matters, the reader should review Alan R. Palmiter, Securities Regulation: Examples and Explanations (3rd edition, 2005).

[47] The Investment Act of 1940, 54 Stat. 789, is codified at 15 U.S.C. 80b-1 to -21. The focus of the law is on those who provide personalized investment advice to specific clients rather than general advice as through a newspaper column; see Lowe v. SEC, 472 U.S. 181 (1985). The Investment Advisor Act of 1940, 54 Stat. 847, is codified at 15 U.S.C. 80a-1 et seq.

[48] Joseph S. Davis, Essays in the Earlier History of American Corporations 234-35 (1965).

[49] See Monographs 28 & 28-A of the Temporary National Economic Committee, 76th Cong. 3rd Sess., Investigation of Concentration of Economic Power (1940 & 1941), quoting the Armstrong Committee's 1906 report.

[50] These issues are discussed in an excellent historical review of the regulation of the insurance industry by Lissa L. Broome and Jerry W. Markham, "Banking and

Insurance: Before and After the Gramm-Leach-Bliley Act," 25 Iowa Journal of Corporation Law 723, 730-32 (2000).

[51] The Reconstruction Finance Corporation (RFC) was established by President Hoover in 1932 to make emergency loans to banks, insurance companies, and railroads in danger of defaulting as the Great Depression deepened. Under President Franklin Roosevelt, the RFC's role was widened to include the purchase of banks' stock in order to provide them with liquid capital and to continue to make loans; more than 7,000 were made during Roosevelt's first term. With the approach of war, the RFC became a major source of financial backing for the nation's military buildup. Beginning June 25, 1940, the agency was empowered to make loans for buying and producing strategic raw materials and for constructing and operating defense plants.

[52] TNEC, Investigation of Concentration of Economic Power, Monograph No. 28A: "Statement of Life Insurance," 76th Cong., 3d Sess. 4 (1941).

[53] U.S. v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

[54] McCarran-Ferguson Act, 59 Stat. 33 (1945); codified as amended at 15 U.S.C. § § 1011-15 (2000).

[55] The variable annuity was invented by the College Retirement Equities Fund (CREF), an affiliate of the Teachers Insurance and Annuity Association (TIAA). The product offers a component of stock investing within the traditional insurance annuity.

[56] SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959).

[57] Broome and Markham, reference in note 50, at 737 (2000).

[58] Demutualization involves the conversion of mutual ownership by policyholders to stock ownership by investors; the primary motivation is to enhance opportunities to raise external capital. Representative companies recently demutualizing include Metropolitan Life, Prudential Insurance, Equitable Life, and Mutual of New York. For materials on demutualization, see Edward X. Clinton, "The Rights of Policyholders in an Insurance Demutualization," 41 Drake Law Review 657 (1992); and Gordon O. Pehrson, Jr., David R. Woodward, and James H. Mann, "Demutualization of Insurance Companies: A Comparative Analysis of Issues and Techniques," 27 Tort & Insurance Law Journal 709 (1992).

[59] Insurance companies have come to believe that federal oversight would simplify the process of regulatory review. Joseph B. Treaster, "States vs. U.S.: Who Will Police Insurance Firms?" New York Times, December 31, 2004; at select.nytimes.com/search/restricted/article?res=F60C1EF63F5D0C728FDDAB0994DC404482. One proposal by Congressman Richard Baker (R-La.) would require states to adopt common standards, thereby avoiding national regulation. "A Crazy Quilt of Rules," Business Week, November 1, 2004; at www.businessweek.com/@@sNWVmIUQ@fB*7QAA/magazine/content/04_44/b3906009_mz001.htm.

[60] Recent return-on-equity (ROE), a standard measure of profitability, in insurance was 11.7 percent; for the same period, the ROE for banking was 15.4 percent and 20.1 percent for diversified financials (including the securities industry). The all-industry composite was 17.3 percent. "Outlook Scoreboard 2005," Business Week, December 26, 2005, 130-53. Data for earlier periods show equivalent results.

[61] Equitable Life became distressed after writing guaranteed investment contracts (GICs) at interest rates substantially above what could be earned from its portfolio

of assets. See, e.g., Lawrence Malkin and Jacques Neher, "French Insurer to Put $1 Billion into Equitable: Axa Buys Stake in U.S. Firm," International Herald Tribune, July 19, 1991; at www.iht.com/articles/1991/07/19/axa_.php.

[62] Various newspaper stories recount these incidents. See, e.g., Barry Meier, "Metropolitan Life in Accord for Settlement of Fraud Suits," New York Times, August 19, 1999, A1; Deborah Lohse, "Suits Settled by Prudential for $62 Million," Wall Street Journal, February 16, 1999, C1; Jenny Anderson, "Indictments Raise Pressure in Insurer Case," New York Times, February 3, 2006, C1, C4 (citing federal civil and criminal indictments against executives of General Reinsurance and AIG).

[63] The McFadden Act of 1927, 44 Stat. 1224, was repealed first by Congress in the Riegle-Neal Act of 1994, Pub. L. 103-328, 108 Stat. 2338 codified at 12 U.S.C. § 1811 (prohibiting and then permitting interstate banking). The Glass-Steagall Act of 1933, 47 Stat. 56, originally codified at 12 U.S.C. 347a, 347b, 412 followed, as repealed by the Gramm-Leach-Bliley Act of 1999, Pub. L. 106-102, 113 Stat. 1338, codified in various sections of 12 and 15 U.S.C. (prohibiting and then permitting commercial and investment banking within the same institution). According to Robert Kuttner, "Financial companies spent $300 million over nearly 20 years to lobby Congress to get it to change the legislation [Glass-Steagall]," "A Requiem for Glass-Steagall," Business Week, November 15, 1999, at 28.

[64] The interested reader may wish to review Sean Wilentz's excellent history of America in the eighteenth century, The Rise of American Democracy: Jefferson to Lincoln (2005).

[65] Portions of the following material are based on Heidi Mandanis Schooner, "Regulating Risk Not Function," 66 University of Cincinnati Law Review 441, 478-86 (1998).

[66] For example, the SEC permits the private placements of securities to qualified institutional investors without meeting the requirements of filing a prospectus and complying with agency review. Rule 144A, 55 Federal Register 17945, April 30, 1990, as amended at 57 Federal Register 48722, October 28, 1992.

[67] Basel II has promulgated rules on risk-adjusted capital requirements of international banks; see www.bis.org. The Basel Committee is currently coordinating such regulation, but its role is simply placed on top of the bank regulators in the U.S. Growth in international exchange linkages and increasing use of electronic transactions are other challenges facing these regulators.

CHAPTER 5: AIRLINES AND THE TRANSPORTATION INDUSTRIES

Success. Four flights Thursday morning. All against twenty-one-mile wind.[1]
Wilbur Wright (1867–1912) and Orville Wright (1871–1948),
Telegram from Kitty Hawk

Transportation has arguably experienced greater deregulation than any other sector of American business. Entire books and long, scholarly articles have been devoted to the history, outcomes, and possible future remedies for the current problems in the industry; see Figure 5-1 for a listing of recent legislation to reduce government oversight of the transportation industries. Rather than a comprehensive review of the situation, this chapter focuses specifically on the airline industry. However, analysis would be roughly equivalent for motor carriers, rail, inland and ocean shipping, and other sectors within the transportation industries.

FIGURE 5-1:
SIGNIFICANT LAWS IN TRANSPORTATION DEREGULATION

Law	Citation	Purpose
Air Cargo Deregulation Act of 1977	Pub. L. 95-163, 91 Stat. 1278	Deregulates air cargo and ends limitations on size of aircraft used to haul freight
Airline Deregulation Act of 1978	Pub. L. 95-504, 92 Stat. 1705	Ends CAB rate, route, and entry/exit governance
Staggers Rail Act of 1980	Pub. L. 96-448, 94 Stat. 1895.	Eliminates most common carrier obligations and grants railroads greatly increased commercial freedom
Motor Carrier Act of 1980	Pub. L. 96-296, 94 Stat. 793	Significantly reduces federal economic regulation of trucking operations
Bus Regulatory Reform Act of 1982	Pub. L. 97-261, 96 Stat. 1102	Liberalizes entry, exit, and pricing of the U.S. bus industry and largely preempts state regulation
Civil Aeronautics Board Sunset Act of 1984	Pub. L. 98-443, 98 Stat. 1704	Ends the existence of the CAB and transfers remaining duties to the Department of Transportation
Trucking Industry Regulatory Reform Act of 1994	Pub. L. 103-311, 108 Stat. 1683	Removes remaining barriers to entry in the trucking industry and eliminates the requirement of tariff filing
Abolishment of the Interstate Commerce Commission in 1995		Transfers remaining functions to the National Surface Transportation Board
Ocean Shipping Reform Act of 1998	Pub. L. 105-258, 112 Stat. 1902	Ends tariff filing and enforcement and simplifies contractual issues with shippers

Note: Pub. L. = Public Law.

EARLY DEVELOPMENTS IN THE AIRLINE INDUSTRY

Nearly every schoolchild knows the story of Orville and Wilbur Wright, including their struggles to fly and the eventual invention of the airplane. The development of heavier-than-air flight was accomplished through their research, was funded by them, and evolved from their knowledge of mechanics and engineering. Once the concept of a commercial aviation industry became a realistic possibility – particularly due to the use of the airplane in World War I – the U.S. government became an active supporter in the industry's growth and development.[2]

By the end of thatwar, the Post Office and the Army coordinated the development of airmail service, originally along the Washington–New York corridor. Routes were rapidly expanded to California and throughout the country, all served initially by military pilots. The high fatality rate among these early flyers (estimated at nearly 75 percent) forced Congress to end the involvement of the military in airmail service, resulting in the privatization of mail carriage.[3]

THE POST OFFICE IN CHARGE

The Postmaster General, who was authorized to award contracts for airmail service, selected five companies whose routes essentially established the route structure for U.S. air service that would largely continue for the next six decades. Commercial aviation began to grow to include both passenger and freight service, and Congress recognized this change by assigning jurisdiction to the Department of Commerce in 1926.[4] The nonstop flight of Charles Lindbergh from New York to Paris the following year greatly increased global enthusiasm for and private and government investment in aviation.

This was an era of cronyism in government, a period that included

Teapot Dome and other scandals of the Harding Administration.[5] A similar incident occurred in the burgeoning airline industry, where the usual government business practice of competitive bidding was ignored in the awarding of airmail contracts. Although the Department of Commerce had responsibility for the safety and maintenance of airways, airports, and air navigation facilities, the Post Office controlled airmail contracts. Desirous of establishing a limited number of large competing airlines, Postmaster General Brown assigned routes at closed-door meetings with airline executives in 1929.[6]

The secret process of awarding routes to a favored few companies[7] was eventually uncovered in a Congressional investigation, which resulted in the termination of these contracts by President Roosevelt on the grounds of collusion between the airlines and the Post Office.[8] New legislation[9] required competitive bidding and a study of the industry, which eventually led to the establishment of the Civil Aeronautics Authority, later renamed the Civil Aeronautics Board (CAB).[10] Safety issues were originally assigned to the Air Safety Board, originally a subagency of the CAB, but later assigned to the independent Federal Aviation Administration (FAA).[11]

DEPRESSION-ERA ECONOMICS

The economic philosophy that drove the subsequent recommendations on the structure of the airline industry may be difficult for the modern reader to appreciate. However, it was entirely consistent with Depression-era concerns that unfair or excessive competition should be suppressed so that air carriers could survive the extraordinary circumstances that existed in the 1930s. There was general concern that the destructive power of competition could harm the industry, lead to further air safety problems, and weaken the ability of the U.S. to defend itself in a time of war. That same attitude permeated New Deal dissatisfaction with the business system and led to the passage of such

legislation as the Robinson-Patman Act of 1936 and the National Recovery Administration, which was subsequently found unconstitutional by the Supreme Court in 1935.[12]

Congress saw aviation as a public utility, not as a private, competitive industry, and as was the case with the railroads and gas and electric utilities, a regulatory structure was created to determine routes, rates, and other matters normally decided by corporate management. As a result, the 1938 act led to the creation of the CAB, a relatively small institution governed by five members. The CAB issued certificates of convenience to the sixteen existing airlines to provide stability and continuity to the industry.[13] World War II then effectively halted civilian activities, and after the war, the CAB attempted to revitalize the industry by authorizing new local carriers to provide feeder services to the existing main or “trunk” carriers.[14] Other authorized services included air taxis and commuter airlines, and such intrastate airlines as Southwest later began operations exempt from CAB jurisdiction.

A MATURING INDUSTRY

Technology and economic prosperity were the most significant developments for the airlines in the period after World War II. Technological innovations included advanced propeller and jet aircraft that allowed passengers to quickly reach their destinations, while the postwar economic boom caused significant increases in the demand for flights for the business and leisure traveler. However, excessive fleet capacity by about 1970 and the 1973 oil embargo and quadrupling of oil prices caused significant economic problems, and the CAB responded by using its regulatory powers to again stifle “destructive” competition.

MORE REGULATION, THEN DEREGULATION

To improve the economic condition of the industry, the CAB imposed a moratorium on new routes, allowed carriers to enter into capacity agreements to limit major market competition (a clear violation of the Sherman Act), and permitted the primary international carriers Pan Am and TWA to swap routes. It was following these actions that consumerism and deregulation began to gain popularity through the work of Ralph Nader[15] and Congressional hearings that supported lessened administrative activity by government.[16] Even the CAB supported less regulation, as stated in an internal report that recommended full deregulation by 1980.[17] The political climate was ready for change, and the election of Jimmy Carter in 1976 began that process.[18]

Carter believed that less government would be good for business and a popular cause, and he was a proponent for deregulation of the transportation industries. He appointed Alfred Kahn, an economist and former chairman of the New York Public Utilities Commission, as chairman of the CAB. Kahn had testified before Senator Edward Kennedy's Subcommittee on Administrative Practice and Procedure and criticized CAB regulation as leading to unduly high air fares, inefficiency, poor customer service, and a tendency toward excess capacity.[19] In searching for allies, he found that Federal Express had been prevented by the CAB from flying large aircraft to reduce operating expenses because of the agency's protection of the trunk carriers who used freight revenues to improve their financial performance. Instead, FedEx was forced to operate smaller planes which were exempted from CAB controls.

Congress responded by passing the Air Cargo Deregulation Act of 1977,[20] after hearings by its own committees, prodding by President Carter, and a general demand for deregulation. Passenger travel received equivalent treatment the following year through the Airline Deregulation Act of 1978.[21] The 1978 act eliminated many controls, including those on entry and exit and

rates, and ended the CAB's existence in a "sunset" provision, effective at the end of 1984.[22] Remaining air transportation duties were transferred to the U.S. Department of Transportation (USDOT), the most important of which is the negotiation and supervision of international airline routes.

DEREGULATION AND THE AFTERMATH

This chapter has focused on the airlines as representative of the transportation industry, as a complete discussion of the railroads, buses, marine shipping, and other modes would require its own book-length treatment.[23] Governments for centuries have treated transportation as having a "common carrier" obligation, that is, to serve all passengers and freight with service open to all upon request and on fair and nondiscriminatory terms.[24] Furthermore, taxpayers have funded the majority of the investment costs in creating the necessary infrastructure for each mode to function, from granting public lands to the railroads for rights-of-way in the nineteenth century to constructing and operating airports in the twentieth century. As a result, transportation has been treated differently from private enterprise; considered more analogous to such public utilities as gas, electric, and water; and subject to regulation in many of its business practices.

LONG-TERM INEFFICIENCIES

The effects of airline regulation, no matter how well intended, were to create inherent inefficiencies and structures that have plagued the industry for much of the last one-third of a century. The major carriers, entrenched by regulatory fiat, assumed they would always receive rate and competitive relief, and when the CAB could not protect their positions, used predatory pricing to try to strangle new entrants in their markets. These companies did not hesitate to overinvest in fleet and airport capacity and to agree to unsustainable contractual agreements with labor unions, while failing to expeditiously move to fuel efficient aircraft.

Deregulation occurred because of the confluence of various factors at a time when there was general disgust over and distrust of a powerful central government.[25] Congress was influenced by free-market economists like Milton Friedman, who believed that regulation inevitably distorts decisions on the allocation of economic resources and results in the "capture" of regulators by a far wealthier industry.[26] Friedman and others believed that unfair business practices were unlikely in open competition, because an airline could easily enter or leave a market (e.g., there were no significant barriers to entry); new entrants could acquire the necessary capital to begin operations (e.g., economies of scale were not insurmountable, particularly when aircraft, gates, and maintenance facilities could be leased); and markets would be competitive and profits would not be unreasonable (e.g., markets were contestable).

Unfortunately, the sudden deregulation of the airline and other transportation industries, when coupled with various negative events (noted in the next section), produced as many failures as successes.[27] Among the successes have been significantly lower fares, increased flight schedules and fewer required connections, and estimated annual benefits to the public of more than $20 billion.[28] Dissatisfactions include more crowded flights; poorer customer service; the collapse of some smaller airlines, often without warning or compensation to ticketholders; the bankruptcy and, in some cases, the reorganization of major airlines; and erratic pricing driven by the conflicting pressures of fuel and other costs and the need to manage seat capacity.[29]

COST PROBLEMS

The most significant factor influencing cost structures has been the

enormous increase in the price of aviation fuel, which has more than tripled in the past decade. Carriers attempt to manage their fuel costs by hedging fuel in the commodities markets and by switching to more efficient aircraft. Other significant costs are labor, with many airline positions covered by collective bargaining agreements; equipment, although leasing has reduced the required cash outlay for the acquisition of aircraft; and weather delays. Standard & Poor's estimates that the percent of total revenues required for the controllable expenses of the industry are as follows:[30]

- Labor 35 percent
- Fuel 20 percent
- Equipment 10 percent

Revenues have been affected by new carriers motivated by the opportunity to compete in a deregulated market; by periodic weakness in the economy; by the reduction in business travel and its accompanying high ticket prices, made possible by new communications and computer technologies and by the declining expectation for businesspeople to meet face-to-face; and by the fear of terrorism and the resulting security checks and delays. It can be argued that no global industry has been more adversely affected by recent events than the airlines. Airline executives were ill prepared to move from a regulated environment to a market economy, and management has not always made wise business decisions. In many respects this is the inevitable result in the period following decades of governmental control, and not inherently the fault of deregulation.

Any fear of anticompetitive behavior has simply not been realized. The mergers that have occurred are primarily survival based rather than oriented to restraint of trade; according to the Brookings Institution, 72 percent of merger activity was based on operational and financial motives, and industry-wide factors accounted for 22 percent. Raising prices and stifling competition do not appear to be a major role in these decisions, and in fact, lower fares are the rule on most routes since deregulation.[31] The Air Transport Association reports that the average inflation-adjusted cost per mile on domestic flights fell by one-half since deregulation.[32] This is no surprise – the marketplace will always price correctly at marginal cost to provide the next seat on an airplane and clear the available supply. Regulators sitting in Washington are merely guessing at the appropriate amount to charge and do so largely on the basis of the recovery of the airlines' average historical costs.

THE HUB-AND-SPOKE SYSTEM

Deregulation forced the major airlines to learn to operate in a market economy without governmental protections or guarantees. An early competitive innovation was the hub-and-spoke system, in which airlines designated major hub cities where they had substantial gate capacity as well as ancillary services like ticket counters, maintenance, and hangar space. For example, hub cities for American and United include Chicago (O'Hare), whereas Continental's hubs consist of such cities as Newark and Cleveland. Radiating from these hubs were spokes to smaller locations served by that airline's regular and commuter aircraft. The passenger would fly into the hub city, experience a one-hour or so connection time to a nearby gate, and fly on to the desired destination.

The resulting "collector" system was intended to manage costs by reducing point-to-point schedules, centralizing maintenance, increasing large aircraft load factors, and using smaller planes for small and mid-size locations. At the time that hub-and-spoke developed, there was some concern that excessive concentration would result at hub airports; that is, one or two airlines would dominate available flights. However, economic analysis does

not support this outcome, particularly as other carriers have maintained competitive levels of pricing and service. The Brookings study determined that fares at hub airports were nearly 6 percent lower (in real terms) than before the hub system, primarily due to the impact of Southwest Airlines and similar smaller carriers.[33]

A COMPETITIVE MARKET

These conclusions do not ignore the peril for the small airlines attempting to seize a share of the airline market. Few of the startups that attempted to operate after deregulation have survived; some were undercapitalized, some were poorly managed, and some were unlucky due to adverse economic conditions. Southwest Airlines and various others have succeeded; the failures are too depressing to list. However, success or failure is the essence of capitalism, and there is no evidence that the U.S. would be better off if competition were replaced by regulators plotting ways to "stabilize" the industry.

Although painful, competition is the appropriate remedy for the airlines and for the transportation industries. If competition leads to oligopoly involving several companies that provide a significant proportion of passenger and freight service, that is the inevitable result in any industry involving some economies of scale. Fears of concentration in the industry are misplaced; a limited number of efficient, profitable carriers would be in the best interests of all stakeholders.

CURRENT AIRLINE ISSUES

Regulation cannot solve the most serious issues facing the airlines: energy costs, unbalanced aircraft and airport capacities, and weather. A fourth issue – terrorism – is being addressed through the Department of Homeland

Security and other federal initiatives, and there are few additional measures that can be taken without delaying and alienating the flying public.

- The problem of the cost of jet fuel can only be addressed by market solutions, including exploration, development of energy-efficient aircraft, and research on alternative fuels. In addition, airlines have become knowledgeable about hedging the cost of fuel through the energy markets, are introducing fuel-efficient aircraft to replace aging fleets, and are eliminating excess weight loads wherever possible.
- Unbalanced aircraft and airport capacity is inevitable in an industry of large egos and reasonable costs of entry, and interference by regulators can only exacerbate the situation in the long run. However, the operators have recently made significant progress in managing their equipment to match expected passenger demand, and 2007 results show that the airlines are flying at 80 to 85 percent of capacity.[34]
- Many readers with flying experience in the past eighteen months can attest to the impact of weather on their travel plans. The most infamous example may be JetBlue's problems over Presidents' Day 2007, when over one thousand flights were cancelled; however, this is only one of numerous weather problems experienced by the airline industry. Operators may lose take-off slots if passengers are allowed to disembark, and an open gate may not be available. Bad weather disrupts a fragile system, one attempting to handle nearly 15 percent more flights than one year earlier with effectively no increase in physical capacity. There were more than 20,000 cancelled flights

in one month in mid-2007, and short of a better air traffic control system (as discussed below), weather delays are inevitable.[35]

What should be done is to adjust those situations that continue to interfere with the workings of the market economy. The sections that follow briefly discuss gate access, mergers, airport capacity and air traffic control, privatization, international open-skies, and consumer protection.

GATE ACCESS

Access to gates at U.S. airports continues to be restricted in such important cities as New York and Chicago. Gates are often unavailable at preferred times or are excessively costly. In some situations, competitive carriers have built their own terminals to guarantee access; examples include the new Southwest facilities at Baltimore-Washington Airport and St. Louis. However, Southwest is profitable, whereas many start-up airlines simply cannot afford this expenditure or are precluded from existing gates by long-term lease arrangements. This situation can be traced to the practice in the years after World War II, when airports expanded based on airline guarantees or outright purchases of revenue bonds issued to fund expansion projects, in return for which they received gate exclusivity or preferential treatment.

Other countries have not been as constrained by these precedents. For example, at some European airports, and at Terminal 3 in Toronto, the airline signage at each gate is electronic so that it can be changed in moments from one airline's name to another. The same technology will be employed at the gates in the new International Arrivals Terminal at New York–JFK, a $1 billion project being developed and operated by a private consortium including the for-profit company that owns and operates the airport in Amsterdam. Airports and airspace are public property, and the practice of exclusive or preferred gate access should not be allowed to continue.

MERGERS

Both the CAB and the antitrust laws have worked against significant merger activity in the airline industry; a recent cancelled attempt was that of US Airways and United in mid-2001.[36] An unregulated industry with significant fixed costs naturally evolves toward oligopoly, and it is difficult to justify the position that airlines remain independent, particularly as they are experiencing profits far below general business levels. Comparative returns-on-equity are provided in Figure 5-2.

Figure 5-2:
Comparative ROEs for American Industry
and the Airlines

	Return-on-Equity	
Airlines		-0.1%
Alaska Air	10.4%	
American/AMR	loss	
Continental	loss	
Southwest Air	7.7%	
US Airways	loss	
Transportation		16.4%
U.S. Industry		17.3%

Source: Data are from "Outlook Scoreboard 2005," Business Week, December 26, 2005, 130-53, and calculated from the most recent company annual financial statements (as of early 2006). US Airways results are based on six months of data because of its merger with America West in 2005.

Nine of the ten largest airlines had losses in 2004, with the exception being Southwest. Standard & Poor's estimates that the combined 2004 loss was $10 billion; "Airlines," S&P Industry Survey, May 2005, §AAR 1.

Among recent problems, United and US Airways filed for bankruptcy protection in 2002 and recently emerged from Chapter 11; Delta and Northwest, which filed in 2005, are in similar situations. Other recent bankruptcy filings included ATA, Southeast Air, Aloha Air, Great Plains Air, and Midway Air.

There is a significant difference between anticompetitive behavior and survival based on sharing reservation, scheduling, pricing, and accounting systems; maintenance facilities and other ground facilities; marketing; aircraft; and other costs. We have argued that the airlines should not be treated as public utilities any longer; they are businesses that must be allowed to search for revenue and cost efficiencies through mergers and a conservative expansion policy.

AIRPORT CAPACITY AND AIR TRAFFIC CONTROL

While total U.S. airport capacity is adequate at the present time, certain airports (Chicago-O'Hare, New York–LaGuardia, and Atlanta) experience chronic overcrowding and delays. The practicable solution will not lie in building new airports, such as has been planned for an area south of Chicago, because of land acquisition and construction costs, environmental and noise concerns, and the chronic problem of raising scarce and expensive capital.[37] More realistic solutions would be improved scheduling through global positioning technology; improved gate access; the imposition of congestion tolls, that is, pricing based on competition for landing slots at peak times; and the modernization of air traffic control systems.

The Air Transport Association is promoting a major modernization of the air traffic control system costing $30–40 billion, shared by the U.S. government and the airlines. The impediments to these actions include the continuing inadequate funding for the FAA, local and state government operation of the airports, and Congressional opposition to most innovative solutions largely for political reasons.[38] This would improve utilization of existing facilities and avoid the collapse of entire FAA regions when computer or other technology failures occur.

As one example of politics at work, the Wright Amendment limits travelers using Love Field in Dallas (primarily Southwest Airlines) to just sixteen cities in Texas and a few surrounding states as a way of protecting the dominant position of the newer Dallas–Ft. Worth International Airport (D/FW). This restriction does not protect the regional economy, as local officials assert; instead, it protects the near-monopoly on long-haul air travel at D/FW dominated by American Airlines.39 While no rational person would end the government's responsibilities in protecting the safety of flying, other barriers – political and otherwise – could be largely overcome by restraining regulation and oversight and by privatization. A recent compromise agreement ends these restrictions by 2014 assuming that Congress and the affected local governments agree.[40]

PRIVATIZATION

The outcry in February 2006 over the plan to entrust a Dubai company with the management of East Coast ports clearly indicates American sensitivity to the privatization of critical transportation facilities. However, as former British Prime Minister Margaret Thatcher so keenly observed, private industry does a far superior job in managing assets than does any government. Assuming that an acceptable manager is found, private-sector control could end political pressures and allow airports to implement rational economic policies including

congestion pricing, open gate access, parking and retail expansion, and other improvements.

There are several examples of private contractor management in the U.S., including Indianapolis and Newburgh, NY–Stewart Airport; see Figure 5-3.[41] Canada has privatized its air traffic control system;[42] the international airport in Sydney, Australia, was leased for $3 billion (U.S.) to Southern Cross Airports Corporation, a consortium led by Macquarie Bank and Hochtief AirPort; and other world locations have adopted this approach to airport and air traffic management.[43]

Figure 5-3:
U.S. Airports Managed by Private Contractors

Airport	Contractor
Air-Carrier Airports	
Atlantic City, NJ	Johnson Controls World Services
Albany, NY	Airport Group Int'l (AGI)
Indianapolis, IN	BAA, USA
New Haven, CT	Johnson Controls World Services
Rochester, MN	Rochester Airport Company
White Plains/Westchester Co., NY	Johnson Controls World Services

Airport	Contractor
General Aviation (GA) Airports	
Alliance Airport, Fort Worth, TX	Alliance Air Services
Brackett Field, LaVerne, CA	COMARCO, Inc.
Capital City Airport, Fairview, PA	Johnson Controls World Services
Compton Airport, Compton, CA	COMARCO, Inc.
Danielson Airport, Killingly, CT	Northwest Air Service
El Monte Airport, El Monte, CA	COMARCO, Inc.
Peru Municipal Airport, Peru, IN	Miami County Air Services
Fox Airfield, Lancaster, CA	COMARCO, Inc.
Republic Airport, E. Farmingdale, NY	Johnson Controls World Services
Whiteman Airport, Pacoima, CA	COMARCO, Inc.
Windhem Airport, CT	Windhem Aerobim, Inc.

Source: The website of the Reason Foundation, at www.privatization.org/database/policyissues/airports_local.html

INTERNATIONAL OPEN-SKIES

For decades, governments used national airlines to market their countries; examples include British Airways, Air France, Lufthansa (Germany), and KLM Royal Dutch Airlines. However, these promotions came at a stiff price; most national airlines chronically lost money until the idea began to be abandoned and the airlines were privatized, merged, or managed efficiently. Similarly, international airports have restricted access to landing rights, giving preference to their own carriers.

Or the airlines were required to make mandatory stopovers at "marginal" airports to gain landing rights in major cities. For example, airlines wishing to fly into Dublin were required to land a portion of their flights at

Shannon in western Ireland. There has been limited progress at what is often called "open skies," access to airports for any carrier able to pay reasonable fees for gates and landing.[44] One estimate is that open skies would reduce fares by 30 percent, primarily in the U.S.-Asian markets.[45]

A historic U.S.–European Union (EU) arrangement was made in 2005 and negotiated into 2007 that apparently allows free access to American and European cities, ending bilateral agreements between the various countries, permitting carriers to continue on to third countries, and ending restrictions on fares and the number of flights. Approval by the EU was delayed by U.S. ownership rules which ban foreign ownership of more than 25 percent of the voting stock in a U.S. airline or 49 percent of the total stock.[46] The George W. Bush Administration has agreed to allow European airlines to exceed this ownership cap without a legal challenge. The existing restrictions reflect political concerns for foreign control of a "critical industry" as well as economic arguments that there could be a significant loss of jobs in the U.S. airline industry.

CONSUMER PROTECTION

Passengers need to be protected from unreasonable and unfair airline practices, and as we have stated throughout this book, consumer protection laws must be maintained. The USDOT reports that complaints have been declining; a recent period showed that the incidence of complaints is less than one per 100,000 enplanements.[47] Consumers continue to note such problems as lost luggage, inadequate information on delayed flights, failure to provide compensation for extra meal or hotel costs when the fault is with the airline (and not the weather), occasional overbooking and bumping of passengers with confirmed reservations, and similar complaints.

There are also situations when airlines have ceased operations, leaving ticketholders without recourse. Obviously, consumers should be leery of patronizing start-up airlines with limited experience. In any event, the USDOT needs to continue and strengthen its programs of consumer protection and assure that remedies are provided, as appropriate.[48]

WHAT THE U.S. SHOULD DO

As the industry struggles to survive, passengers continue to fly. A recent FAA estimate is that the volume of U.S. passengers will rise 45 percent in the next twelve years to more than one billion, attracted mostly by low fares.[49] This means that aircraft and airways will be more crowded, and innovative structural changes will be required to manage the traffic loads. Private-sector initiatives should be encouraged to enable the transportation system to proceed without further disruptions.

While regulation may have been appropriate at a time when the shipping public needed protection from the monopoly power of the railroad barons, changing competition, technology, and national interest inevitably led to deregulation in the transportation industries. The public utility analogy is no longer sufficient to justify special treatment, and competitive response has become paramount in survival or failure. The true deregulation of the airline industry (as opposed to the 1978 version) would involve measures to improve access to gates for all airlines, permission for strategic mergers to allow airline companies to achieve economies of scale, actions to increase capacities at airports and in the air, privatization of publicly owned facilities, and a policy of open skies in global markets.

ENDNOTES FOR CHAPTER 5

(Endnotes)

[1] The rest of this famous message announcing the invention of the airplane is as follows: "Started from level with engine power alone. Average speed through air thirty-one miles. Longest fifty-nine seconds. Inform press. Home Christmas." Telegram to the Reverend Milton Wright, from Kitty Hawk, NC (December 17, 1903).

[2] An excellent history of the transportation industry is Paul Stephen Dempsey and William Thoms, Law and Economic Regulation in Transportation (1986); this point is discussed at page 26. For a recent, thorough analysis, see Dempsey's article "Transportation: A Legal History," 30 Transportation Law Journal 235 (2003).

[3] Contract Air Mail Act of 1925, 43 Stat. 805 (1925).

[4] Air Commerce Mail Act of 1926, ch. 344, 44 Stat. 568 (1926).

[5] See David H. Stratton, Tempest over Teapot Dome (1998).

[6] This history is discussed in Alexander T. Well and John G. Wensveen, Air Transportation: A Management Perspective (5th edition, 2003), 33-45.

[7] The companies receiving the favored treatment were Northwest Airways, United Air Lines, Transcontinental and Western (predecessor to TWA), and Eastern Air Lines.

[8] Although Postmaster General Brown's motives were suspect, all corruption charges were eventually dropped.

[9] Black-McKellar Act, 48 Stat. 933 (1934).
[10] Civil Aeronautics Act of 1938, 52 Stat. 973 (1938).

[11] The approaching introduction of jet airliners and a series of midair collisions spurred passage of the Federal Aviation Act of 1958, Public Law 85-726, 72 Stat. 731. For additional information, see www.faa.gov.

[12] The National Recovery Administration (NRA), 48 Stat. 195 (1933), was created by the National Industrial Recovery Act to have industries create codes of behavior to reduce destructive competition and to help workers by setting minimum wages and maximum weekly hours. Most economic historians consider the NRA to be a failure, as the codes allowed cartels to be established in many industries. As these firms increased their prices, sales fell, employment fell, and the recovery from the Great Depression stalled. The legal dispute arose from the labor provisions of the NRA code, with the Court holding the law invalid on grounds of the attempted regulation of intrastate transactions which only indirectly affected interstate commerce. A.L.A. Schechter Poultry Corporation v. U.S., 295 U.S. 495 (1935).

[13] James Callison, "Airline Deregulation – A Hoax?" 41 Journal of Air Law & Commerce 747, 758 (1975).

[14] In addition to the original four carriers (referenced in note 7), those issued certificates were American, Braniff, Chicago & Southern (merged subsequently into Delta), Continental, Delta, Inland (merged subsequently into Eastern), Mid-Continent (merged subsequently into Braniff), National, Northeast, Penn Central (merged subsequently into United), and Western. Paul Stephen Dempsey, "The State of the Airline, Airport and Aviation Industries," 21 Transportation Law Journal 129, 139-40 (1992). Readers will note that several of these companies no longer exist or have been involved in recent bankruptcy reorganizations.

[15] Nader's organization of law students published a 1,200-page critique of the ICC; Robert Fellmeth et al., The Interstate Commerce Omission (1970). Nader's subsequent book, Unsafe at Any Speed (1972), which discussed the automobile industry, brought him worldwide fame.

[16] Senator Kennedy (D.-Mass.) chaired the Senate Judiciary Subcommittee on Administrative Practice and Procedure. Hearings conducted by that committee resulted in the Kennedy Report, which concluded that deregulation would permit pricing flexibility and generally improve the profitability of the airline industry. See "Oversight of Civil Aeronautics Board Practices and Procedures," U.S. Senate Comm. on the Judiciary, Subcomm. on Admin. Practice and Procedure, 94th Cong. (1975). See also Stephen Breyer, Regulation and Its Reform (1982).

[17] Roy Pulsifer and CAB Staff, Regulatory Reform: Report of the CAB Special Staff (1975).

[18] A thorough analysis of the pressures driving airline deregulation is in a paper by Jeffrey W. Hayes, "Airline Deregulation: A Financial Markets Perspective on Who Mattered When"; at polmeth.wustl.edu/mailinglist/posting.php?id=243&title=August%201998&order=dateposted&startdate=1998-08-01&enddate=1998-08-31.
[19] See Alfred E. Kahn, The Economics of Regulation (1971).

[20] Public Law 95-163; 91 Stat. 1278 (1977), codified at 49 U.S.C. § 44301-2.

[21] Public Law 95-504; 92 Stat. 1705 (1978), codified in sections of 49 U.S.C. § 41505 and at 49 U.S.C. § 49101.

[22] Civil Aeronautics Board Sunset Act of 1984, Public Law 98-443, 98 Stat. 1704, codified at 49 U.S.C. 419.

[23] Indeed, Paul Steven Dempsey's article "Transportation: A Legal History," referenced in note 2, runs to over 78,000 words, 130 pages, and nearly 1,200 footnotes!

[24] In Munn v. Illinois, the Supreme Court upheld state regulation of certain enterprises that were of such character as to become quasi-public institutions; see 94 U.S. 113 (1876). The Court cited English practice to regulate ferry service and common carriers in its decision.

[25] It should be noted that the Airline Deregulation Act was passed only a few years after the Watergate investigation and Nixon's subsequent resignation and pardon. Negative public opinion toward the incumbent Ford Administration was a determining factor in the election of Jimmy Carter in 1976, and it was during the Carter Administration that Kahn was appointed chairman of the CAB and Congress passed airline deregulation.

[26] Paul Stephen Dempsey, "Market Failure and Regulatory Failure as Catalysts for Political Change: The Choice between Imperfect Regulation and Imperfect Competition," 46 Washington & Lee Law Review 1, 26-28 (1989).

[27] One estimate is that the two decades after deregulation (the 1980s and 1990s) saw 150 airline bankruptcies, the cessation of more than 1,000 motor carrier operations, and the merger of the two national bus companies, Greyhound and Trailways. Paul Stephen Dempsey, "Running on Empty: Trucking Deregulation and Economic Theory," 43 Administrative Law Review 253, 254 (1991).

[28] According to an older Brookings Institution study, fares are roughly 27 percent lower than under regulation. Steven A. Morrison and Clifford Winston, "The Remaining Role for Government Policy in the Deregulated Airline Industry," in Deregulation of Network Industries: What's Next? (Sam Peltzman and Clifford

Winston, eds.), AEI-Brookings Joint Center for Regulatory Studies, 2000, 1-2.

[29] As one personal example, the author had the experience of flying from New York to San Antonio to present a talk at a conference in 2005. My round-trip ticket cost $300; my seatmate's round-trip ticket cost $850 (and he was in a center seat!).

[30] "Airlines," S&P Industry Reports, May 2005, § AAR 24.

[31] Morrison and Winston, referenced in note 28, at 17.

[32] Reported in "Why the Skies Have Gotten Crowded," Wall Street Journal, July 21-22, 2007, A5.

[33] See note 31, at 4-7.

[34] See note 32.

[35] Ibid.

[36] The most significant merger in recent years was the American (number 2 in the industry) combination with TWA (number 8) in 2001.

[37] In 2004, the South Suburban Airport Commission held a competition and selected a team led by LCOR and SNC-Lavalin to finance, design, build, and operate what is now called Abraham Lincoln National Airport. The Illinois Department of Transportation is buying land at the preferred site in Peotone, forty miles south of downtown Chicago. The basic model is a public-private partnership, with government owning the land and the private entity owning and operating the facilities.

[38] Airlines are now arguing for more input to the modernizing and financing of the air-traffic system in the U.S.. "Big Airlines Want Greater Voice in Reshaping Air-Traffic System," Wall Street Journal, March 9, 2006, D4.

[39] The Wright Amendment (named for former Speaker of the House of Representatives Jim Wright) was included in the International Air Transportation Competition Act of 1979, Public Law 96-192, 29, 94 Stat. 35 (1980) (the amendment has never been codified). The Shelby Amendment, passed in 1997, added Kansas, Alabama, and Mississippi to the list of states where carriers may fly directly from Love Field; Department of Transportation and Related Agencies Appropriations Act of 1998, Public Law 105-66, 337, 111 Stat. 1425, 1447 (1997). For a review of this situation, see Jennifer C. Wang, "Comment: Time for Congress to Spread Love in the Air: Why the Wright Amendment was Wrong Before, and Why It Deserves Repeal Today," 70 Journal of Air Law & Commerce 353 (2005). A compromise to end this situation was announced in 2006, but restrictions continue for eight years before being eliminated. See "Carriers End Feud on Flights and Ticketing at Love Field," New York Times, June 16, 2006, C8.

[40] See "Who Won in the Wright Amendment Compromise?" Aero-News.Net, June 16, 2006, at www.aero-news.net/index.cfm?ContentBlockID=a382181a-323a-4a63-afe0-1d33e6e48d49.

[41] The Stewart Airport received FAA approval in April 2000 of its ninety-nine-year lease to a British company, National Express. The airport has managed to attract several new tenants providing aviation services, and its passenger count increased by 33 percent in 2004, topping the growth rate of all other U.S. airports. The new Chicago airport will be similarly managed. For a description of the program related to the Stewart privatization, see www.reason.org/apr2005/air_transportation.shtml.

[42] The new company is called Nav Canada; see its Web site, www.navcanada.ca. For a comparison of Nav Canada and the FAA, see Bruce D. Nordwall, "Under New Management; Pushing the FAA to Become a Customer-Focused and Performance-Based Entity Will Require Dramatic Changes in Thinking as Well as Organization," Aviation Week & Space Technology, February 9, 2004, 44.

[43] For current information on transportation privatization, see the Web sites of the Reason Public Policy Institute, at www.rppi.org; and the National Center for Policy Analysis, at www.ncpa.org.

[44] The U.S. has negotiated more than seventy open-skies agreements with various countries, including India, Canada, and many EU countries. For a complete list and other data, see the State Department's Web site, www.state.gov/e/eb/rls/othr/2005/22281.htm. For a legal analysis of the issues in U.S. open-skies, see Christopher Furlan, "Foreign Ownership and Control Restrictions in U.S. Airlines: Barrier to Mergers and Restructurings," 2005; at www.abanet.org/pubutil/resources/writingcomp/furlan05recipientweb.doc. For a brief comment on the current status of European open-skies, see "Flying the Liberal Skies," Global Insight, 2007, at www.globalinsight.com/Perspective/PerspectiveDetail9072.htm. For a news story on the apparent conclusion of U.S. and EU negotiations, see Nicola Clark, "U.S. and Europe in Accord on Air Routes," New York Times, March 3, 2007, C3.

[45] Steven A. Morrison and Clifford Winston, The Evolution of the Airline Industry (Brookings, 1995).

[46] See Susan Carey, "Airlines 'Open Skies' Accord May Not Fly," Wall Street Journal, February 27, 2006, A4. The applicable law is the Federal Aviation Act of 1958, Public Law 85-726, 72 Stat. 731, codified as amended at 49 U.S.C. § § 1301-1557 (1988).

[47] See the USDOT's report at airconsumer.ost.dot.gov/reports/2006. The lowest number of complaints were registered about Southwest and JetBlue in the 2005 reporting period, while the highest number were against airlines that have ceased operations or were in bankruptcy, including US Airways and Independence Air. Obviously, a truer picture is obtained by reference to carriers with ongoing operations, and their incidence of complaints appears to be stable at about half of the overall reported rate.

[48] Complaints can be submitted to the USDOT through its website, at airconsumer.ost.dot.gov/problems.htm.

[49] The complete forecast is available at the FAA's website, www.faa.gov.

CHAPTER 6: CORPORATE GOVERNANCE

Great cases, like hard cases, make bad law.[1]
Oliver Wendell Holmes, Jr. (1841–1935), Northern Securities Co. v. U.S.

Justice Holmes could have been referring to the recent business ethics/fraud/insider trading cases (hereinafter grouped as the "fraud cases"), including Enron, WorldCom, Martha Stewart, or any of the others that have resulted in investigations, criminal convictions, plea bargains, and civil fines.[2] He might also have been referring to regulatory responses hastily enacted to "protect" against corporate fraud, which may do a bit of good while doing significant harm.[3] At the same time, it seems clear that the fraud cases have increased the general level of market risk and reduced market valuations, other things, including corporate earnings, remaining constant. Since markets seem to have failed, regulation might seem to be worth trying even if it is unlikely to help.

"THERE OUGHTA BE A LAW!"[4]

Corporate governance has become a defining business issue of the early twenty-first century, and in some ways is nearly an obsession with legislators and regulators. Although there have been numerous instances of outrageous behavior throughout American economic history, Congress – following the republican tradition – long rejected demands for federal legislation on how public companies should be managed. As Roberta S. Karmel notes, early SEC Chairman (and later Supreme Court Justice) William O. Douglas criticized the full disclosure philosophy of the Securities Act of 1933 (see the Brandeis comment in Chapter 4 [at footnote 39]) in its failure to protect uninformed investors who "either lack the training or intelligence to assimilate … and find … useful [financial statement data]."[5]

FEDERAL REGULATORS GET IN THE GAME

For four decades Congress denied the SEC overt regulatory power over most actions by corporations on the theory that such activities historically have been subject to state jurisdiction.[6] However, the atmosphere of corporate corruption in the post-Watergate era allowed the agency some leeway. As a result, the SEC began prosecuting or threatening to prosecute situations involving illegal political contributions and questionable foreign payments.[7] Later SEC programs involved the composition and independence of boards of directors, shareholder access to the corporate electoral process, the public accounting profession, and other matters of corporate governance. Congress assisted these attempts at federal intervention by passing the National Markets Improvements Act of 1996, which preempted state law governing corporate behavior in the area of securities regulation.[8]

The Sarbanes-Oxley Act of 2002[9] ("Sarbox") broke new ground by mandating that U.S. publicly traded corporations regularly assess their processes to ensure transparency and protect shareholder value. The law was enacted to restore investor confidence by requiring actions concerning financial reporting, conflicts of interest, corporate ethics, and accounting oversight. Heavy fines for senior managers and their corporations, and even imprisonment, are available remedies under Sarbox; the idea was to construct a strong enough incentive for business executives to obey the law.

SUNBEAM: A CASE OF FRAUD

The slippery slope of fraud often begins with managing financial numbers to meet analysts' and Wall Street's expectations. Apparently, the senior managers at Sunbeam expected that the future periods would be successful enough to make up for earlier shortfalls. The situation at Sunbeam occurred early in the most recent cycle of fraud cases. Chairman and Chief Executive Officer "Chainsaw" Al Dunlap authorized misstatements in financial reports to meet investors' and analysts' expectations for Sunbeam's stock. To raise cash, Sunbeam sold $60 million in accounts receivable and initiated an "early buy" program for gas grills, allowing retailers to "purchase" grills in Fall 1997 but not to be paid until mid-1998. Once the retailers were loaded up with grills, Sunbeam started a second sales program. A "bill and hold" plan permitted customers to buy and store their unpaid merchandise in Sunbeam's facilities.

The two sales arrangements accounted for a major portion of the revenue gains in 1997 but were in fact future sales booked now. As a result of Sunbeam's misleading actions, a series of class action lawsuits were filed on behalf of all persons who purchased the common stock through April 1998. The complaints charged Sunbeam with issuing a series of materially false and misleading statements regarding Sunbeam's fourth quarter 1997 and first quarter 1998 sales and earnings. Investigation by the SEC finally resulted in payments by Sunbeam of $18.5 million to settle various lawsuits while denying any wrongdoing. Dunlap appears to have many millions left and has never faced criminal charges.

IS REGULATION THE ANSWER?

One of the disadvantages of the democratic system is that bad law or regulations are sometimes enacted to appease an angry public. As we previously discussed, the Glass-Steagall Act was law from 1933 until 1999; Congress passed Glass-Steagall to separate investment and commercial banking, to end the evils of a few unscrupulous financiers whose stock manipulations "caused" the October 1929 stock market collapse. History has shown that many other factors led to the crash and the Great Depression and that financial market excesses played a relatively minor role.

Our purpose is not to plow over the thoroughly documented fraud cases that led to the current obsession over corporate governance. Rather, the subject is the choice of the remedies selected by Congress to steer the behavior of senior corporate executives. In short, is the benefit to the public worth the cost? Expenses have risen for business for everything from accounting and legal fees to a higher cost of capital for multinational corporations unwilling to list on American exchanges. Society pays for such administrative costs as new governmental oversight and regulation and such judicial costs as indictments, trials, and prison time.

This book keeps repeating the theme that more regulation is not necessarily the best solution. Rather, with all their imperfections, contract and market-based approaches are more likely than regulation to reach efficient results. Sarbox reforms rely on increased monitoring by independent directors, auditors, and regulators, who have both weak incentives and low-level access to information. This monitoring has not been and cannot be effective in dealing with fraud by highly motivated insiders. The only effective antidotes to fraud are active and vigilant markets and financial market professionals with strong incentives to investigate corporate managers and uncover relevant information.

IMPORTANT SARBOX PROVISIONS

Sarbox makes new law in several important areas, some of which may create havoc for corporate managers, accountants, and regulators. Some of the more difficult provisions are noted below.

CERTIFICATION

Chief executive officers are now required to certify that a periodic financial report "fairly represents, in all material respects, the financial condition and results of operation of the issuer."[10] A knowingly false certification can result in a fine of up to $5 million and imprisonment of up to twenty years. Although Sarbox does not contain any clarification for this process, many public companies are requiring junior and middle-level managers to "subcertify" the sections of the financial reports for which they are responsible. One survey noted the following areas as the most common areas where financial professionals were being asked to subcertify, leaving them with unresolved issues of liability:

- disclosures in management's discussion and analysis or in footnotes
- specific account balances in banks
- compliance with company policies and procedures
- adequacy of internal controls in their department or business function
- compliance with company code of conduct[11]

AUDIT COMMITTEE INDEPENDENCE

A continuing problem with public companies is the "rubber stamp" attitude of many boards of directors, whose responsibility is to protect the interests of shareholders and other stakeholders. This situation occurs because outside directors – those not employed by the company – are frequently too busy to attend to corporate affairs with appropriate diligence. Another contributing factor is the cronyism and lack of independence of inside directors who are not likely to comment critically on the actions of the chairman or chief executive officer, who is also their boss. The SEC has long recognized this dilemma and has pursued various initiatives to increase the participation of outside directors on audit committees.[12]

Sarbox establishes independent audit committees with authority over external auditors and requires disclosure of whether an audit committee includes a financial expert.[13] Financial reporting has effectively become the responsibility of the audit committee, and that body is a potential antagonist of and separate from the CEO and CFO. The audit committee and its members must be independent and cannot be compensated for other services provided to the company. With these and other rules, Sarbox places the audit committee in a unique position in the corporation, overriding hundreds of years of state regulation and the principle of senior executives having responsibility for the affairs of the corporation.

WHISTLEBLOWING

Because fraud requires the participation of several people, most of whom are relatively junior employees, there is only slight potential to maintain secrecy over an extended period of time. Sarbox supports internal whistleblowing by establishing a civil cause of action that protects employees

of publicly traded companies who assist in the investigation of conduct that the employee "reasonably believes" is a prohibited action. Criminal liability is established for whistleblower retaliation, and audit committees of public companies are required to establish procedures for "the receipt, retention, and treatment of complaints."[14]

The inherent problem with protection for whistleblowers is that any employee could reveal proprietary secrets to the media or to government on the grounds that something illegal is going on, when the real intention is to "get even" for some real or imagined injustice. Such revelations might be entirely without merit, but the damage would have been done. Whistleblowing by angry employees is inevitable; according to one estimate, the SEC's Enforcement Complaint Center annually receives more than 20,000 communications on potentially illegal corporate actions.[15] There are no statistics on the rate of validity to these claims.

REGULATION OF THE ACCOUNTING PROFESSION

The failure of Arthur Andersen in 2002 was caused by the accounting firm's participation in several fraud cases, the most critical of which undoubtedly was Enron.[16] Congress feared a general loss of investor and business community confidence in auditors and the independence of their opinions in financial reports. In addition, lawmakers were not convinced that the accountants' self-regulatory organization, the Financial Accounting Standards Board (FASB), would have adequate power to restore credibility. As a result, the Public Company Accounting Oversight Board (PCAOB) was created in Sarbox to be the federal regulator over the profession.[17]

The PCAOB has responsibilities to register and inspect public accounting firms that prepare audit reports for public companies; adopt and modify auditing, quality control, ethics, independence, and other standards for public company audits; investigate registered accounting firms for violations of rules relating to audits; and impose sanctions for violations. To prevent conflicts of interest, other provisions prohibit accounting firms from providing most consulting-type services, require periodic rotation of the audit partner, and impose restrictions on audit professionals from becoming senior executives at their client companies.[18] It is unclear whether these changes are adequate, as accounting judgment can still be compromised by the desire to please clients to retain audit business and to collect additional fees for Sarbox compliance services.[19]

OTHER CORPORATE INITIATIVES

Other selected initiatives required of company executives include the following:

- Loans are prohibited to directors and executive officers, including the modification and forgiveness of currently outstanding loans.[20]
- Executive bonuses must be forfeited when financial restatements result from corporate misconduct.[21]
- All material off-balance-sheet transactions and arrangements must be disclosed.[22]
- Pro forma financial statements must be reconciled with generally accepted accounting principles.[23]
- Internal controls must be explained as to their management and assessment.[24]
- Management must reveal whether a code of ethics has been adopted.[25]

CHANGING DEMANDS ON CORPORATE GOVERNANCE

Modern regulatory theories of corporate governance began with Berle and Means,[26] who argued after the 1929 stock market crash that owners of publicly held corporations could not effectively control their corporations. This effectively involves two problems. First, as Adam Smith observed, corporate managers do not watch over "other people's money" with the "anxious vigilance with which the partners in a private copartnery frequently watch over their own."[27] In other words, public corporations involve agency costs, including the owner's costs of monitoring the agent, the agent's cost of posting a bond to protect the owner, and residual losses that agents impose on owners despite monitoring and bonding. Second, agency costs are not trivial because it is impractical for shareholders with small, dispersed interests to invest much time and money in monitoring managers.

MANAGERS IN THE FRAUD CASES

The fraud cases appear to involve a new breed of corporate executives who were unconstrained by traditional restraints.[28] These executives are hypermotivated survivors of a highly competitive environment (Enron called its periodic manager evaluation process "rank and yank") who proved their ability to make money while putting on a veneer of loyalty to the firm. In the words of Larry E. Ribstein, "They are Machiavellian, narcissistic, prevaricating, pathologically optimistic, free from self-doubt and moral distractions, willing to take great risk as the company moves up and to lie when things turn bad, and nurtured by a corporate culture that instills loyalty to insiders, obsession with short-term stock price and intense distrust of outsiders."[29]

An understanding of the perpetrators' motives would seem to be essential in designing regulation that has a significant chance of preventing future frauds. It is too simplistic to ascribe these frauds to "greed" without accounting for the risk of detection. None of the main characters in the recent scandals have absconded with the loot beyond buying expensive homes. Moreover, the alleged perpetrators were not shady criminals but seemingly responsible business people who had earned the trust of their even more respectable monitors. For example, Scott Sullivan, who was convicted of manipulating WorldCom's books in order to meet earnings targets, was regarded as "one of the best chief financial officers around" and "the key to WorldCom Inc.'s financial credibility."[30]

How could such a man have engaged in blatant financial manipulation? Similar questions arise regarding the blatant behavior of some Enron insiders, including the former CEO Kenneth Lay, CFO Jeffrey Skilling, and treasurer Andrew Fastow. Indeed, the insiders' conduct seems particularly puzzling, at least at first glance, given agents' usual incentives. Since agents bear severe penalties in firms if they fail, including loss of job and reputation, but normally do not get the full benefit of success, it follows that they would tend to be more cautious than their employers would want them to be, rather than the reverse.

CONTRIBUTIONS OF ACCOUNTING TO THESE PROBLEMS

The process often begins with journal entries made by company accountants without knowledge of their accuracy as verified by physical counts of materials, work-in-process and finished goods inventories, machinery, and other company assets.[31] We rely on internal auditors to verify these entries, but a substantial portion of their energies are now devoted to Sarbox compliance. The external accountant then provides an independent audit of financial records and opinions as to the accuracy of the financial statements presented by the business enterprise. It has not been the external accountant's job to seek or discover situations involving fraud or to warn the company of possible control

failures.

Carefully worded opinions are then prepared regarding the extent of their responsibilities and investigations. Typical language is: "These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on the statements based on our audits." As audits are currently performed, it is fairly clear that a clever fraud will not be detected by the external accountant. Even when fraud has been detected, auditors can resign from clients but are under no compulsion to publicly disclose the reasons. Despite these limitations, this system worked reasonably well until the accounting firms (e.g., Arthur Andersen) aided the business frauds by failing to adjust to the new profit-maximization goals versus their traditional, professional focus.[32]

THE OUTSIDE AUDITORS

Arthur Andersen and other firms pressed the business side, exhorting its partners to sell nonaudit services like consulting and tax planning to audit clients and tying partner compensation to business production. These firms used their auditing services, which firms must buy, as "loss leaders" to sell nonauditing services. In some situations, auditors' loss of independence in effect may have made them part of the management team. Years of working for a client, with prospects of joining the client's management and participating in its success, may have made auditors subject to the same pathologies that affected client management, including excessive optimism and loyalty, and reduced their concern for their auditing firm's reputation.

The fraud cases illustrate weaknesses in the auditing of corporate ledgers. In general, the problems have involved some combination of excessive ties between auditing firms and the companies they are supposed to be scrutinizing, inadequate review of the accounting firm's work by corporate audit committees, inadequate industry or government scrutiny of accounting firms' work, and excessively lax accounting standards. Even the largest accounting firm may have an incentive to overlook misconduct from a client from which it makes significant fees for consulting and other nonaudit work. Auditors may believe that their conclusions are honest, but only because their judgments are affected by a "self-serving" bias to view behavior in the most favorable light.[33]

DRIVERS OF FRAUD

Senior insiders face punishment in the form of job and reputation loss even for lawful conduct that fails to meet investor expectations – that is, for their firm's failure to meet investors' earnings expectations. These managers may believe that they are no longer susceptible to potential discipline by their firms or the employment market because failure to distort earnings also will result in loss of their job and reputation.[34] Since executives are convinced that they are doing the right thing in defending their company's value from destruction by misguided markets, they are also not subject to a significant moral constraint.

Once fraud begins, the result is additional alterations of manager incentives. At this point, insiders risk loss of wealth and even personal freedom unless they continue the cover-up. Indeed, the consequences of discovery may be so severe that even a small chance of success might lead a rational person to cover up. This calculus may be reinforced by a psychological tendency to prefer risk when choosing whether to take a present loss or take a chance on avoidance or on future loss.[35]

Strong measures may be necessary to significantly reduce the risk of future fraud. Insiders who think that they are doing the right thing may be harder to detect and deter than those who were simply greedy. Effective deterrence

may also be very costly. Moreover, given the shift in incentives when the end seems near, increasing punishment may actually increase the risk of a cover-up, even as it has little effect on the fraud itself. All of this suggests significant uncertainty about how best to craft the law to prevent future frauds.

PROBLEMS WITH THE REGULATORY APPROACH

Regulation can send a signal to investors that helps shape their behavior and may mislead them into inaction. If this hypothesis is correct, then additional regulation, accompanied by new exaggerated claims for its efficacy, might inhibit markets from self-adjusting to fraud by giving investors a reason for continued complacency. For example, Sarbox provisions calling for increased SEC review of corporate filings[36] and a significantly increased SEC budget[37] may give investors the impression that the SEC is effectively protecting them. This is an additional reason for being concerned about the actual effectiveness of these and other proposed regulatory responses to corporate fraud.

OTHER "UNINTENDED CONSEQUENCES" [38]

Sarbox has been a misdirected reaction to solve a problem where there is ample prosecutorial and market surveillance of corporate activity, assuming that investors and analysts care to make the effort. As long as the penalties remain, concern over a possible Sarbox violation by some corporate manager may lead to one or more of the following outcomes:

- Competent individuals may be reluctant to serve on boards or as senior executives, given the potential for investigation by federal regulators conceivably leading to jail time.

- Financial managers will spend much of their time on compliance issues rather than on developing the optimal capital structure for their companies.[39] One report states that there is general dissatisfaction at careers in finance due largely to Sarbox;[40] in Chapter 9 we examine specific situations faced by these managers.
- A huge increase in fees has and will be paid to accounting firms, lawyers, consultants, and risk managers for guidance on Sarbox compliance and the development of internal control processes.
- Auditors will choose conservative treatment of accounting entries motivated by self-defense and their fear of an Arthur Andersen–type meltdown rather than by the desire to accurately match revenues and expenses.
- Plans will be reconsidered and perhaps shelved by multinational and private U.S. corporations that are considering a listing of their shares on U.S. exchanges, given the clearly restrictive requirements of Sarbox.
- There will be ongoing worry and litigation as to what constitutes "fair" and "material," as there are no objective standards on the certification of statements. The chief executive officer who guesses wrong may well be indicted.

WHO'S IN CHARGE, THE FEDS OR THE STATES?

As previously noted, the traditional regulators of business have been the states following the mandate and Supreme Court interpretations of the Commerce Clause; for example, corporations are creatures of state law"[41] and the finding that Congress did not have the power to create federal law that

would replace the "entire corpus of state corporation law."[42] Sarbox changes this landscape, by assigning powers to the SEC to regulate corporations that were never previously within the purview of a federal agency.

The states are scrambling to decide what future path to take, particularly as they largely ignored the situations that led to the Enrons, WorldComs, and Tycos. In at least one situation – that of the State of New York – the reaction by the attorney general's office has been to institute prosecutions against the more notorious alleged perpetrators, including the New York Stock Exchange, AIG, Moody's Investors Services, SONY BMG Music, and several others. Most states have been content to let the SEC lead the charge, particularly given the "capture" of many state officials by corporations through contributions to election campaigns.

The individual investor is probably indifferent as to whether the states or the federal government protects his or her interests, as long as there is no repetition of the financial scandals of the past fifteen years. For business managers, the danger is that the free market orientation of American capitalism could turn into control by government regulation, with the SEC effectively setting policy on compensation, accounting and financial procedures, acceptable risk limitations in business strategy, and other matters more properly the job of directors and senior managers. Whatever its faults, state law has been accommodating and has encouraged risk taking, allowing such successes as Microsoft, Starbucks, and e-Bay; federal regulation can be heavy handed and limiting and may result in second guessing by Washington bureaucrats that could interfere with innovation and creativity..

MARKET RESPONSES TO FRAUD

The corporate governance problem goes beyond the issue of U.S. jurisdiction, affecting companies in Europe and Asia. There have been scandals in every major economy, from Vivendi, Parmalat, and Royal Ahold in Europe to financial companies and the keiretsu cartels in Japan and Hyundai and the chaebol cartels in South Korea.[43] Significant differences exist in each region's reaction, with the U.S. clearly the most stringent with regard to the extent of the required controls for public companies and the penalties for executives who are successfully prosecuted. No evidence yet exists that Sarbox is the most rational approach to preventing future incidents. The only commonality is that the fraud occurred, the fraud is discovered, and the fraud is prosecuted.

Before adopting regulatory solutions, thoughtful American lawmakers should have considered the feasibility of market-based responses. Market-oriented discipline has high prospects of success now that the risks of defective accounting have become as obvious to market participants as they have become to politicians, regulators, and the public. Indeed, it was markets and not regulators that uncovered the problems and adjusted the share prices of offending companies, while years of regulation of securities disclosures and of the membership of boards of directors failed to prevent the business fraud cases. In other words, dishonest insiders were able to "outrun" the kinds of monitors that regulators favor; ultimately (if belatedly) the markets exposed these situations. If markets can react, there are significant benefits to allowing them to do so.

Markets can significantly reduce their vulnerability to fraud simply by paying closer attention to warning signs. This might include watching for discrepancies in the figures of similar firms within an industry,[44] reading such fine print as financial statement footnotes, and relying on "harder" numbers such as free cash flow that are not affected by firms' decisions on capitalizing and amortizing expenses. Market skepticism is more likely now that investor biases have appeared to move from over-optimism to neutrality or pessimism. In the current environment, firms, analysts, auditors, and others have a strong incentive to signal their integrity and independence.

EXPLICIT COSTS OF SARBANES-OXLEY

There are limited "hard" data on the implementation costs of Sarbox, primarily because companies have requirements that must be accomplished by certain dates following enactment in 2002. Various results have been reported in media stories about the cost thus far of Sarbox compliance, all suggesting that the expense for each company is in the multi-millions of dollars and that the total cost would be in the billions of dollars. Most board directors now believe that the benefits of compliance are not worth the costs, particularly as the law is causing senior managers to become more risk averse.[45]

Compliance costs were expected to rise by 4 percent in the second year and decline by 2.5 percent thereafter. One study found that average audit fees about doubled in 2004 for Fortune 1000 companies, while another estimate was for a three-fifths increase. In 2005, it has been estimated that the total cost of Sarbox would exceed $6 billion.[46] Nearly 60 percent of smaller companies (those with annual total revenues under $1 billion) reported that compliance was costly.[47] In a separate study, AMR Research estimated that Fortune 1000 companies would spend an aggregated $2.5 billion,[48] while Financial Executives International (FEI) reported the amount as closer to $4.5 million.[49]

It is estimated that audit costs would increase by 30 percent annually,[50] partly as a result of new auditor responsibilities and also because of higher hourly audit fees. The Big Four[51] have focused on their largest, most profitable clients, pushing some corporations to second-tier firms less knowledgeable about their clients' businesses.[52] Many executives have stated that reforms are too strict, and one-quarter agree that the costs outweigh the benefits. Furthermore, audit firms appear to be less willing to provide guidance on regulatory issues.[53]

Businesses with more than $5 billion in revenue expect to spend nearly \$5 million to implement Section 404, according to Financial Executives International, with expenditures on consultants, attorneys, audit fees, software, and information technology. Ongoing costs for each company will be some \$1.5 million.[54] Compliance with Section 404 requirements will involve spending \$300 million on process automation solutions.[55] The Wall Street Journal reports that there is no evidence that Section 404 rules will protect investors despite the enormous billing by accounting firms (estimated at 12 million hours) and internal company efforts (perhaps 120 million hours). This survey estimates Section 404 costs at \$10 to \$13 billion and suggests that the promise of Sarbox may create "a false sense of security" for those who may be injured by future business frauds.[56]

WHAT THE U.S. SHOULD DO

To paraphrase Justice Holmes's comment noted at the beginning of this chapter, bad law can result from anger and revulsion at the criminal acts of a few. The then-chairman of the PCAOB, William McDonough, stated that "the reason this legislation is so tough is because the American people rose in fury."[57] To a large extent, this explains the muted reaction of portions of the business community when Sarbox relief is discussed, although some corporate leaders have been vocal in their opposition.[58] The current position of the legislative leaders is silence or continued belief that the costs are justified to strengthen American capital markets.[59] However, other leaders are worried and are preparing studies of the impact of Sarbox on the economy.[60]

In the fraud cases, many levels of market and monitoring devices simultaneously failed. Proregulatory theorists argue that this demonstrates that securities markets cannot be trusted to work on their own without strong regulatory support and that the new regulation was needed to restore investor confidence. However, we have attempted to show that the case for significantly

increased regulation has not been made. While the fraud cases have exposed gaps in the existing monitoring structure, the benefits of eliminating those gaps are not as clear as they might seem to be. Aggressive executives determined to ignore the risks of their actions, including their personal exposure to punishment, breached the existing regulatory framework. Promoting more independent monitors with lower-powered incentives to scrutinize the actions of highly informed and motivated insiders cannot solve this problem.

Furthermore, the costs of increased regulation are significant. On the one hand, Sarbox may reduce the incentives of both insiders and monitors to increase shareholder value. Even if the law is ineffective, Sarbox could cause harm simply by misleading the market that regulation can solve its problems. In fact, as history has often shown, from the South Sea Bubble to the Great Crash,[61] frauds manage to stay one step ahead of the regulators. Even if some highly sophisticated and nuanced regulation theoretically could increase social welfare, it is not likely that this type of reform will arise out of the present highly charged political environment.

The resulting private and public costs may far exceed any potential benefits. Expenses will rise for business for everything from accounting and legal fees to a higher cost of capital for multinational corporations unwilling to list on American exchanges. Society will have to pay for such administrative costs as new governmental oversight and regulation, and such judicial costs as indictments, trials, and prison time. Meanwhile, corporate criminals will continue to commit white-collar crime – they will just be cleverer and more circumspect – while the rest of the world looks at the U.S. in disbelief at its high-mindedness.

ENDNOTES FOR CHAPTER 6

(Endnotes)

[1] Supreme Court Justice Holmes continued: "For great cases are called great, not by reason of their real importance in shaping the law of the future, but because of some accident of immediate overwhelming interest which appeals to the feelings and distorts the judgment"; 193 U.S. 197, 400 (1904), dissenting opinion. In 1904, the Supreme Court ruled in favor of the government's Sherman Act challenge to the Great Northern and Northern Pacific railways combination.

[2] The press coverage on the various fraud cases is so extensive that this book makes no attempt to review these situations. For a review of developments at two companies, see Bethany McLean and Peter Elkind, Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron (2003); and Lynne W. Jeter, Disconnected: Deceit and Betrayal at WorldCom (2003). However, some cases have been resolved or are being tried following the publication of these and similar reportage; the interested reader is encouraged to consult daily news accounts. For a discussion of the impact of the fraud cases on the role of directors, auditors, and lawyers, see "The Boss on the Sidelines," Business Week, April 25, 2005, 88.

[3] Joan M. Heminway cites ten law reviews or other sources on the rush with which the primary corporate governance legislation, the Sarbanes-Oxley Act, was enacted; the actual total is probably closer to fifty such well-reasoned complaints. "Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance," 10 Fordham Journal of Corporate and Finance Law 225 (2005), her note 19.

[4] A comic strip drawn by Jimmy Hatlo (1898–1963); see dlib.lib.ohio-state.edu/cga/html/101-200/0175.html.

[5] Roberta S. Karmel, "Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance," 30 Delaware Journal of Corporate Law 79, 83 (2005), quoting Douglas, "Protecting the Investor," 23 Yale Review 521, 523-24 (1934).

[6] Article I, section 8 of the U.S. Constitution, generally referred to as the Commerce Clause, is cited as the justification for the states to regulate intrastate commerce including the formation of corporations. Congress does have the power to so regulate in certain situations. For example, in U.S. v. Darby Lumber, 312 U.S. 100 (1941), although only some of the goods manufactured by Darby were to be shipped through interstate commerce, the Supreme Court held that the Fair Labor Standards Act could be applied to the intrastate production of those goods. In general, however, the Supreme Court maintains that Congress did not intend to replace the "entire corpus of state corporation law"; Burks v. Lasker, 441 U.S. 471, 478 (1979).

[7] Various cases were brought by the SEC beginning about 1975. See the Federal Securities Law Reporter (Commerce Clearinghouse) for actions against Lockheed (95,509, 1975–1976) and ITT Corp. (96,948, 1979). The situation of American companies paying bribes was so repugnant to Congress that the Foreign Corrupt Practices Act of 1977 was passed to assess criminal penalties; Public Law 95-213, 91 Stat. 1494, 15 U.S.C. § § 78m, 78dd, 78ff.

[8] Public Law 104-290, 110 Stat. 3416, codified in sections of 15 U.S.C.

[9] Private companies are not subject to Sarbox. Public Law 107-204, 116 Stat 745 (2002). For the complete text, see frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=f:publ204.107.

[10] § 906 of Sarbox, 116 Stat. 806; codified at 18 U.S.C. § 1350.

[11] By one estimate, one-third of all companies now have subcertification requirements, with employees required to sign an affidavit vouching for information that ultimately appeared in their company's financial reports. The legal liability for this action is completely unknown, and attorneys have expressed varying opinions as to the effect of subcertifications on a future prosecution under § 906. Association for Financial Professionals, "The Buck Stops...With Me?" (white paper on subcertification issues) (2003); at www.afponline.org/pub/pdf/SOX_white_paper.pdf.

[12] For a brief review of these initiatives, see Karmel, reference in note 5, at 108-13.

[13] § 301, 15 U.S.C. 78j-1-5 (2002).

[14] These three requirements are in § § 806, 1107, and 301(4), and codified in 18 U.S.C. 1514A and 1513 and 15 U.S.C. 78j-l(4), respectively.

[15] As reported for the fiscal year 2005; 20 percent concerned the actions of public companies. For additional information, see the SEC's website, at www.sec.gov/news/data.htm. Arguably the most famous whistleblower in recent times is Sherron Watkins, a senior accountant at Enron. Her statements to CEO Kenneth Lay were ignored, and she eventually left the company. See Mimi Swartz and Sherron Watkins, Power Failure: The Inside Story of the Collapse of Enron (2003).

[16] For a review of the Andersen situation, see Barbara Ley Toffler and Jennifer Reingold, Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen (2003).

[17] This provision is particularly notable because accountants had previously been answerable to state boards of accounting and to the American Institute of Certified Public Accountants, a self-regulatory organization. The Public Company Accounting

Oversight Board (PCAOB) is contained in § 101, 15 U.S.C. 7211 (2002).

[18] § 201, 15 U.S.C. 78j-1(g); § 203, 15 U.S.C. 78j-1(j), and § 206, 15 U.S.C.78j-1, respectively.

[19] See Don A. Moore, Philip Tetlock, Lloyd Tanlu, and Max Bazerman, "Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling," 31 Academy of Management Review 10 (2006).

[20] § 402(k), 15 U.S.C. 78m(k) (2002). This provision is quite disruptive of such normal business practices as travel advances and loans to exercise stock options.

[21] § 1103, 15 U.S.C.78u-3 (2002).

[22] § 704, 15 U.S.C. 7201 (2002).

[23] § 401, 15 U.S.C. 78m (2002).

[24] § 404 of the Sarbanes-Oxley Act, codified at 15 U.S.C. § 7262, requires companies to assess their internal financial controls and requires auditors to review and certify that assessment. This has proven to be the most costly and most controversial section of Sarbox. The report must "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting"; codified at 15 U.S.C. § 7262(a)(1).

[25] § 406, 15 U.S.C. 7264 (2002), promulgated by SEC Regulation S-K, 17 C.F.R. § 229.406 (2004).

[26] Adolf Berle and Gardiner Means, The Modern Corporation and Private Property

(1932).

[27] See Adam Smith, Wealth of Nations, Vol. 2, 741 (Glasgow edition, 1976).

[28] See William W. Bratton, “Enron and the Dark Side of Shareholder Value,” George Washington University Law School, Working Paper No. 035 (2002); at papers.ssrn.com/abstract=301475.

[29] “Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002,” 28 Journal of Corporate Law 1, 9 (2002).

[30] See Shawn Young and Evan Perez, “Finance Chief of WorldCom Got High Marks on Wall Street,” Wall Street Journal, June 27, 2002, B1.

[31] It is likely that the reporting of cash and marketable securities is largely accurate as these amounts are taken from bank and brokerage statements. Because of the judgment required in accrual accounting, the reporting of just about every other balance sheet asset and most income statement accounts are subject to manipulation or error. (Liabilities are owed by contract to vendors, creditors, lenders, and employees, so there is little dispute as to the accuracy of those amounts.

[32] Jeffrey N. Gordon, “What Enron Means for the Management and Control of the Modern Business Corporation,” 69 University of Chicago Law Review 1233 (2002).

[33] See Max H. Bazerman, Kimberly P. Morgan, and George F. Loewenstein, “The Impossibility of Auditor Independence,” 38 Sloan Management Review 89, 91 (1997).

[34] For discussions of the effect of the final period problem on insiders’ incentives

to commit wrongdoing, see Jennifer H. Arlen and William J. Carney, “Vicarious Liability for Fraud on Securities Markets: Theory and Evidence,” 1992 University of Illinois Law Review 691 (1992); and Mitu Gulati, “When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure,” 46 UCLA Law Review 675 (1999).

[35] See Richard W. Painter, “Lawyers’ Rules, Auditors’ Rules and the Psychology of Concealment,” 84 Minnesota Law Review 1399 (2000); and Jeffrey J. Rachlinski, “Gains, Losses, and the Psychology of Litigation,” 70 California Law Review 113 (1996).

[36] § 408, codified at 15 U.S.C. 7266.

[37] The budget of the SEC increased by $133 million or 17.6 percent from fiscal year 2004 to fiscal year 2005; calculated from data on the SEC’s website, at 3; reference at note 15.

[38] The so-called Law of Unintended Consequences states that most human actions have at least one unintended consequence. The concept dates back to the Scottish Enlightenment in the second half of the eighteenth century. Sociologist Robert K. Merton popularized the concept in the twentieth century.

[39] For a report on the situation by the search firm Russell Reynolds, see “Upfront: CFOs Sing the Sarbox Blues,” Business Week, May 29, 2006, 11.

[40] See “Upfront: Sore About Sarbox,” Business Week, March 13, 2006, 13. One reported statistic is that half of all respondents in a CFO Magazine survey stated that “complying with Sarbox has made my job less satisfying.” Few thought that Sarbox would help their careers.

[41] Cort v. Ash, 422 U.S. 66, 84 (1975), in commenting on 18 U.S.C. 610, which prohibits corporations from making contributions or expenditures in connection with specified federal elections.

[42] Burks v. Lasker, 441 U.S. 471, 478 (1979), in commenting on the coverage of the Investment Company Act of 1940.

[43] Business Week and other media have published various articles on the scandals in Europe and Asia. For example, a survey of the leading cases is provided in "Europe's Year of Nasty Surprises," March 10, 2003, at www.businessweek.com/magazine/content/03_10/b3823071_mz014.htm?campaign_id=search. The changes resulting from these incidents are reported in "Europe's Old Ways Die Fast," May 17, 2004, at www.businessweek.com/magazine/content/04_20/b3883018.htm?campaign_id=search. Asian problems are noted in "Cracking Down on the Chaebol," March 10, 2003 (discussing South Korea), at www.businessweek.com/magazine/content/03_10/b3823074_mz014.htm?campaign_id=search. However, the problems continue; see "Where Will Bribe Scandal Steer Hyundai?" April 27, 2006, at www.businessweek.com/globalbiz/content/apr2006/gb20060427_765019.htm?campaign_id=search; Martin Fackler, "Hyundai Arrest Shakes Foundations of South Korean Industry," New York Times, May 20, 2006, C1, C4; and Chloe Sang-Hun, "Daewoo's Founder Is Given 10-Year Sentence for Fraud," New York Times, May 31, 2006, C6. For a discussion of a Japanese scandal in financial services, see "A Big Stink Speeds Up Tokyo's Big Bang," July 7, 1997, at www.businessweek.com/archives/1997/ b3534102.arc.htm?campaign_id=search.

[44] For example, stock analysts should have more closely investigated WorldCom when it was the only telecommunications company to report a positive net income in 2001 and the first quarter of 2002. This was accomplished by capitalizing expenditures that properly should have been expensed. (Capitalized costs are

depreciated over a time period established by the FASB and the Internal Revenue Service, usually five to ten years. This has the effect of making an expense one-fifth to one-tenth of the amount that should have been reported in the year that it was first incurred.)

[45] The survey results are discussed in "Why Some Directors Want to Scream: Enough!" Directorship, April 2006, at www.rhrinternational.com/Files/Board%20Survey%20Results%20RHR.pdf.

[46] All of these estimates were compiled by the Wall Street Journal; see Diya Gullapalli, "Living with Sarbanes-Oxley," Wall Street Journal, October 17, 2005, R1; at online.wsj.com/article_print/SB112922100637567825.html. The various studies were performed by the University of Nebraska, the law firm of Foley & Lardner, and AMR Research, respectively.

[47] David M. Katz and Lisa Yoon, "Is Sarbox Costly? Yes It Is, No It Isn't," CFO.com, July 7, 2003; at www.cfo.com/article.cfm/3009830.

[48] Sean Nolan, "Calculating Costs of Sarbanes-Oxley Compliance," e-week, issue of August 13, 2003; at www.eweek.com/article2/0,1759.

[49] Amy Borrus, "Learning to Love Sarbanes-Oxley," Business Week, November 21, 2005, 126.

[50] Deborah Solomon and Cassell Bryan-Low, "Companies Complain about Cost of Corporate-Governance Rules," Wall Street Journal, February 10, 2004; at online.wsj.com/ad/article/ironmountain/ SB107636732884524922.html.

[51] The Big Four (as of 2007) are Deloitte Touche Tohmatsu, Ernst & Young, KPMG Peat Marwick, and PriceWaterhouseCoopers.

[52] See "The Little Guys Doing Large Audits," Business Week, August 22, 2005, 39.

[53] "Sarbanes-Oxley Backlash Emerges as Controllers Consider Total Cost of Compliance," Controllers Report 1 (2004); at www.afponline.org/mbr/res/oh/272_a_2.html.

[54] Section 404 requires that each annual financial report contain an internal control report, stating management's responsibility for creating and maintaining an adequate control structure and procedures for financial reporting; and assessing the structure and procedures currently in place. "Sarbox Section 404 Could Cost Big Companies $4.6 Million Each," SmartPros, February 12, 2004; at accounting.smartpros.com/x42491.xml.

[55] Sophie Louvel, "IT Spending for Compliance: From SARBOX 404 to Comprehensive Compliance," Bank Systems & Technology, August 25, 2004; at www.financetech.com/story/databasemanagement/showArticle.jhtml?articleID=26805611.

[56] Ira Solomon and Mark E. Peecher, "SARBOX 404—A Billion Here, A Billion There ...," November 9, 2004, page B2; at online.wsj.com/article_email/0,,SB109995736741968209-IhjeoNilah3oJuvbXqGbK6Hm4,00.html.

[57] Reported in Tim Reason, "Feeling the Pain: Are the Benefits of Sarbanes-Oxley Worth the Cost?" CFO Magazine, May 2005, 50, 55. The supposed public consensus resulted in only three dissenting votes being cast when Sarbox was passed by Congress.

[58] For example, a 2005 survey by Christian & Timbers, an executive search firm, reported that a third of nearly 200 executives at Fortune 1000 companies favor repeal

of Sarbox. Ibid., at 52.

[59] A few Congressmen support Sarbox reform with particular focus on §404. However, the leadership has yet to make specific legislative proposals although House Speaker Nancy Pelosi has made comments on possible changes. See Stephen Barlas, "Congress Opens the SarbOx Box," Financial Week, January 15, 2007, 1, 21.

[60] There have been at least three major reports since mid-2006: the Committee on Capital Market Regulation (with endorsement by U.S. Treasury Secretary Henry Paulson); a study by the U.S. Chamber of Commerce; and a McKinsey Consulting analysis (commissioned by New York City Mayor Michael Bloomberg).

[61] For a review of these and other incidents, see Charles P. Kindleberger, Manias, Panics, and Crashes: A History of Financial Crises (4th edition, 2001).

PART II:
The Effects of Business Regulation

After hearing the brief explanation by Sue Lawless of U.S. regulation (see Part I), the MegaFi executives are obviously concerned that it might take years to gain the necessary approvals to proceed with the Universal Mortgage product, at least in America. Seymour, Will, Sue, and the other executives wonder if perhaps the company should investigate less onerous regulatory environments in other jurisdictions. At least from a distance, they conclude that the regulatory model developed by the United Kingdom – that of the super regulator – has a great deal of theoretical appeal. This is becoming an increasingly popular approach and has been implemented in various major countries.

The MegaFi executives wonder whether the concept would be appropriate for the U.S. and if an industry lobbying effort would be a useful step. Of course, they realize that while there have been some efforts at deregulation there is still a climate in the U.S. that supports the continued oversight of business. They are also concerned about the ability of the U.S. to compete in an increasingly global economy. They also question how MegaFi will be able to compete against strong global financial companies in the future.

CHAPTER 7:
REGULATION: THE FOURTH BRANCH OF GOVERNMENT

"Government of the people, by the people, for the people…"
Abraham Lincoln (1809–1865), Gettysburg Address

In Part I of this book we reviewed five fairly diverse areas of regulation, including those pertaining to specific industries and to business in general. In order to keep the discussion to a manageable length, we did not attempt to comprehensively analyze every area of business oversight that survives early in twenty-first-century America; it has been left to others to examine the agencies and departments that control communications, energy, and other industries that operate under some degree of federal jurisdiction. The areas of regulation and the regulator that were discussed are listed in Figure 7-1; others include the Federal Communications Commission (FCC), the Commodity Futures Trading Commission (CFTC), the Federal Energy Regulatory Commission (FERC), and the Nuclear Regulatory Commission (NRC).

Figure 7-1:
Areas of Regulation and the Federal Regulator (as discussed in Part I)
(regulatory agencies in italics)

Antitrust	Department of Justice *Federal Trade Commission*	DOJ *FTC*
Banking	*Office of the Comptroller of the Currency*	*OCC*
Financial Services	*Securities and Exchange Commission* Insurance regulated by state commissions	*SEC*
Airlines	Department of Transportation *Federal Aviation Authority*	DOT *FAA*
Corporate Governance	*Securities and Exchange Commission* *Public Company Accounting Oversight Board*	*SEC* *PCAOB*

REGULATION OF U.S. BUSINESS

It is highly unlikely that Jefferson, Lincoln, and the other great American leaders envisioned regulatory agencies as a fourth branch of government, and there certainly is nothing in the Constitution or the Federalist Papers that discusses the phenomenon.[1] Yet that is precisely what developed at times of national crisis, including banking during the Civil War, antitrust during the populist movement of the late nineteenth century, financial services and the airlines during the Depression, and corporate governance during the financial scandals at the turn of the present century. Temporary situations that threaten the security of the country must be addressed, but actions that seemed

necessary at an earlier time may no longer be appropriate to the needs of the present. To their everlasting credit, the founders were building for permanence, not for temporary emergencies.

This chapter reviews the development of the American concept of regulation; explains the continuing struggle over control between the President and Congress, with periodic review by the judiciary; and notes the current situation with regard to external changes in industries affected by business regulation. We then describe two important areas of regulation – antitrust and banking – in other developed societies, in the analysis of comparative global experiences.

THE POPULIST CRISIS

Regulation assumes that free markets will not function to efficiently allocate factors of production and that competition will be subverted to the disadvantage of consumers. There have been abundant instances of this outcome throughout the history of the U.S.. However, each situation, with the exception of banking, has been of a relatively short duration, driven largely by an economic emergency that eventually was resolved.

Presidents and Congressmen cannot wait for cycles to naturally end; if they do, people will be without jobs and may starve, there may be a significant loss of confidence in the future, the country could become ungovernable, and elected officials will be voted out of office. A businessman-engineer like Herbert Hoover waits for the inevitable cyclical upswing, does nothing, loses his bid for re-election, and is generally considered as one of America’s worst presidents. A professional politician like Franklin Roosevelt sees a problem, knows that something must be done, does it, and was one of our greatest presidents.

The Interstate Commerce Commission (ICC) was not reviewed in

Part I because it no longer exists. However, it is instructive to note that, after banking, the ICC was the first agency characterized by regulatory oversight and not a part of an existing cabinet department.[2] The paradigm that was created ensured that shippers would have access to rail services at standard rates as established in a schedule of public tariffs. The ICC was empowered to assure reliability and used its Congressional mandate to control entry and exit and to regulate rates so that reasonable but not excessive profits would be earned by the railroads.

This structure continued even though the motor carrier industry became a viable competitor to rail after World War I, and in fact, the ICC later created a separate regulatory organization for this new transportation mode.[3] Following populist agitation for relief from the unfair practices of the trusts, Congress enacted the Sherman Act in 1890 and two additional laws in 1914 designed to assist in the implantation of antitrust policy; these laws were discussed in Chapter 2.

THE GREAT DEPRESSION CRISIS

The next major economic disaster addressed by Congress was the Stock Market Crash of 1929 and the ensuing Great Depression. To avoid nationalizing private enterprise, a "solution" that was used in Europe in the 1930s, or other anticapitalistic measures,[4] President Franklin Roosevelt (FDR) decided to follow the successes of his cousin Theodore and use free trade and regulation to "save" capitalism; see comments on FDR in Chapter 4 with regard to financial services. Although it is not generally remembered today, FDR's Secretary of State Cordell Hull was a strong supporter of free trade and convinced the President to push the Reciprocal Trade Agreements Act of 1934[5] through Congress, reversing the high tariff barriers enacted in the Smoot-Hawley Act of 1930.[6]

Regulatory "alphabet soup" was the principal economic pillar of the first FDR administration. Agencies such as the Agricultural Adjustment Administration (AAA), the National Recovery Administration (NRA), and the Civilian Conservation Corps (CCC) were among numerous attempts to create jobs and raise prices industry and farmers received for their production.[7] At the beginning of his first administration, FDR encountered the problem that the existing regulatory agencies were creatures of Congress and ostensibly independent. This does not imply that the President was restrained in his attempts to influence policy,[8] and in fact, the issue of Congressional versus executive control did not receive a hearing until 1935.

WHO'S IN CHARGE, THE PRESIDENT OR CONGRESS?

The Supreme Court's opinion in Humphrey's Executor v. U.S.[9] decided that a regulatory agency was an "administrative body created by Congress to carry into effect legislative policies . . . . Such a body cannot in any proper sense be characterized as an arm or an eye of the executive."[10] FDR had attempted to remove a member of the Federal Trade Commission because of policy differences. This conclusion has been widely criticized[11] and largely ignored by various modern presidents in their attempts to "manage" the goals of the regulators.

The problem of the control over regulatory agencies derives from the wording of the Constitution, specifically Article II, which states that "The executive Power shall be vested in a President of the U.S. of America" (the Vesting Clause) and that "[the President] shall take care that the laws be faithfully executed" (the Take Care Clause). Proponents of the supremacy of the President use Article II to argue that the power of Congress to divest the President of control of the executive branch is limited. Therefore, it may be argued that independent regulatory agencies are unconstitutional to the extent that they exercise discretionary executive power and are not controlled by the President.

Critics note that the Constitution grants Congress the exclusive power to "make all Laws which shall be necessary and proper for carrying into Execution ... all ... Powers vested by this Constitution in the Government of the U.S., or in any Department or Officer thereof"; that the Constitution grants Congress the exclusive power "To make Rules for the Government and Regulation of the land and naval Forces"; and that the Constitution specifically obligates the President to "take Care that the Laws be faithfully executed." Commentators generally refer to the power of Congress to pass laws and to the separation of powers as the actual intention of the framers.

The issue has never been absolutely resolved by the Supreme Court with regard to the regulatory agencies and has been a matter of some debate for some time.[12] However, it is clear that departments of the executive branch, such as the Department of Justice and the Department of Transportation, are subject to presidential control, while the independent agencies are creatures of Congress but subject to presidential appointment and influence.

ANSWER TO WHO'S IN CHARGE: IT DEPENDS!

This situation is relevant because the majority of business regulation is a creature of the Legislative rather than the executive branch. Once created by law, a regulatory agency is substantially independent and generally focuses on its narrowly defined mission unless redirected by Congress. The few significant legislative changes to regulatory agencies, noted in Part I, included the demise of the ICC and the CAB and the expansion of the duties of the SEC to include corporate governance. However, it has usually been difficult to interest Congress in fixing regulatory problems; as an example, see the comment in Chapter 4 regarding the efforts and years required to pass deregulation in the

financial services industries.

Regulatory changes through forceful Presidential leadership have occurred, usually in times of national emergencies. Action is demanded, and it is fortunate that most Presidents have taken the necessary steps to safeguard the Republic. During the crisis of the Great Depression, FDR responded with pressure on the existing regulatory agencies and the creation of new bodies. As Angel Moreno notes, he used such tactics as appointing and removing commissioners, jawboning, and public relations to coerce desired behaviors.[13]

REGULATORY CHANGES SINCE FDR

An important FDR advisor, Harvard Law School professor and later Supreme Court Justice Felix Frankfurter, persuaded his protégé James Landis to come to Washington to assist with the administration's oversight of business practices. Landis arrived in early 1933 when the economy was at its nadir, with one-quarter of the labor force unemployed. He and other New Dealers conceived the idea of using regulatory agencies to administer the necessary policy to resuscitate the economy and prevent future disasters. The vision was to create and empower agencies that could respond to the Depression unhampered by the slow pace of congressional debate.[14] The Humphrey's Executor case provided the agencies sufficient flexibility to accomplish the intended independence of action.

THE GROWTH OF THE FOURTH BRANCH

The most prominent agency created during the early years of FDR's first term was the SEC, which was conceived as the regulator to prevent stock market abuses through increased disclosure and required independent audits. The SEC's first chairman was Joseph P. Kennedy, the father of future President

John F. Kennedy. The concept of federal securities regulation received public support when Richard Whitney, the president of the New York Stock Exchange and a leading opponent of the new regulatory environment, was accused of embezzling tens of millions of dollars to cover his debts. Whitney was eventually convicted and imprisoned.[15]

Landis later wrote that the concept of the regulatory agency was necessary because of "the inadequacy of a simple tripartite form of government [Congress, the President, and the courts] to deal with modern problems." The fourth branch of government – the administrative branch – would be comprised of parts of the three other branches (in Landis's words, "quasi-legislative, quasi-executive, quasi-judicial") to use expert staff in the implementation of policy.[16] As a result of the exigencies of the 1930s, the regulatory idea vested new authority in the existing ICC and FTC and in the new agencies: the Federal Power Commission, the SEC, the FCC, the CAB, and the National Labor Relations Board. In sum, Congress avoided difficult political issues by assigning broad power to regulatory agencies that were able to use and extend their powers with relatively scant scrutiny from the courts.[17]

Eventually there was concern about the spreading regulatory umbrella, and FDR appointed the Brownlow Committee to review the administration of the federal government.[18] The final report criticized the independence and spread of the regulatory agencies and recommended that the executive branch manage their functions. It was in this report that the often-quoted observation appeared of regulators as "a headless fourth branch of government" that had created "a haphazard deposit of irresponsible agencies and uncoordinated powers."[19]

PRESIDENTIAL STRUGGLES WITH THE FOURTH BRANCH

The Presidential struggle to regain the control envisioned by the original framers of the Constitution has continued through current times with various results. FDR prudently foresaw the more pressing problems of the impending world war and limited his requested changes to the assignment of budgetary control over the regulators to the executive branch.[20] President Truman sponsored the appointment of the first Hoover Commission,[21] chaired by the former President, which ultimately defended the validity of the independent agency. A second Hoover Commission was created early in the administration of President Eisenhower;[22] its findings focused on the need for greater federal government coordination.

Studies during the Kennedy and Ford Administrations recommended that mechanisms be developed for agency coordination rather than basic changes in the management structure of the "fourth branch."[23] The tortured history of efforts at Presidential control includes procedures stated in executive orders and Office of Management and Budget (OMB) directives. Every President since Nixon has attempted to achieve some degree of supremacy, and the devices with the most sustained success have been budgetary control and the appointment power of commissioners. When matters do reach the courts, the deregulation era tends to favor the executive branch rather than the earlier deference to Congress.[24]

THE PATH TO DEREGULATION

While Congress has shown limited enthusiasm to address the regulatory environment, there has been an important shift in the goals of the regulatory agencies. While the original intent was to control the relations of business with its customers, the current focus is to promote competition.

FROM REGULATION TO DEREGULATION

Movement toward deregulation has been accomplished through three general schemes:[25]

- Detariffing – the elimination of the requirement that the regulated companies file schedules of rates and service for agency approval
- Unbundling – the ending of packages of bundled (linked) product groupings, allowing customers to choose specific service elements that meet their requirements
- Ending cross-subsidies – the practice of subsidizing certain customers who might pay less than the average cost for their services by fees paid by supposedly wealthier customers, thereby moving closer to the economists' objective of pricing at marginal cost[26]

These initiatives mean that the regulator is now expected to intervene only when the markets do not demonstrate competitive behavior.

This is significant progress on the path to deregulation and in some ways reflects the shifts in the marketplace faced by businesses both in the U.S. and throughout the globe. Legislators who enacted regulation seven or more decades ago could not have anticipated the speed of the changes in technology, the intensity of the struggle for survival and growth, and opportunities in international markets. A comment on the first two of these influences follows; the discussion of global competition will be deferred to Chapter 10.

TECHNOLOGY

Advances in technology have eliminated many of the monopolistic attributes of industries regulated by Congress. Although we did not review the communications industry in Part I, it has clearly undergone a revolution in nearly every aspect. The FCC cannot cope with satellite radio, telephony through the Internet, or any of numerous recent technologies. The pace of development has forced established service providers to continuously innovate, to create new distribution systems, and to merge with or acquire competitors.[27]

Technology has similarly altered the airline and the motor carrier industries, with new equipment and routes available that significantly reduce operational costs while allowing much faster delivery of service. A few examples:

- The airlines have taken advantage of the enormous expansion of airport capacity despite the less dynamic changes to air traffic control; see Chapter 6.
- Refinements in motor carrier design and engines allow double- and triple-tandem hauls (where permitted by state law), and the Interstate Highway System has significantly reduced total travel times.
- Intermodal cooperation – such as piggybacking[28] – provides a combination of speed, flexibility, and cost efficiencies.

SURVIVAL AND GROWTH

In some situations, participants in a regulated industry have advocated deregulation. At times the situation appeared to be sufficiently hopeless that deregulation was perceived to be the only alternative; the railroad industry is a leading example.[29] Regulatory failure was often blamed for the problems of that industry,[30] and the railroads believed that they needed freedom to abandon unprofitable service and to raise rates. As a result, they actively participated in the drafting of legislation on deregulation.[31]

Similarly, after the dissolution of the Bell system,[32] the new regional Bell operating companies (RBOCs) actively supported deregulation so as to be allowed to enter markets proclaimed off-limits. Various methods of political persuasion were used, including pressure on the Department of Justice, lobbying of Congress and the FCC, and further litigation.[33] The Telecommunications Act of 1996 permitted the RBOCs to enter businesses from which they had been excluded in the 1982 order, including long-distance and equipment manufacturing.[34]

Other market participants such as cable television and radio broadcasters also influenced the 1996 Act. This list can be expanded to include companies in the energy business endorsing the Energy Policy Act of 1992;[35] the banking industry (except for community banks who feared for their existence) in anticipation of the Riegle-Neal Act of 1994; and the financial services industries that supported the Gramm-Leach-Bliley Act of 1999.

SELECTED GLOBAL REGULATORY EXPERIENCES

While the situation with regard to business regulation has evolved to a less vigorous posture, the fact is that the agencies continue to exist and the laws remain on the statute books. It is unlikely that the regulators would be oblivious to political pressure or public opinion in making decisions on when to take action. However, there is no assurance that a new executive or Congress will not change direction and try to reinstitute 1930s-era controls. For example, the recent near-chaotic conditions in the airline industry could have led to a call to reinstate the CAB; fortunately, that has not happened

(yet).

While the U.S. has been a leading advocate of regulation, other nations have had similar histories. Selected experiences and attitudes may be instructive in considering appropriate policy. Other than banking, the oldest and most influential American regulatory "products" are antitrust and financial services. How do our friendly competing regional economies or nations handle these regulatory issues?

ANTITRUST IN EUROPE

Europe borrowed various American ideas in its struggle to recover from the devastation of World War II. Although the concept of a common market and later a European Economic Community was not envisioned by the various nations at war's end,[36] the Western European nations eventually signed the Treaty of Rome that led to the current-day European Union (EU).[37] The treaty included agreements on the competitive behavior of companies and the anticompetitive actions of member nations such as providing subsidies to local businesses.[38] European antitrust is similar to American law[39] and is embedded in the laws of the EU and in the laws of the various countries. In most situations, the EU takes precedence.[40]

The curious but perhaps predictable course of enforcement by the EU has been largely doctrinaire without much evidence of "rule of reason" thinking based on injury to consumers. At least a portion of the explanation for this outcome is that enforcement is through a large EU bureaucracy that does not answer to voters or even to national governments. Some commentators also suggest that the European attitude may be simply because of the need to create a strong, controlling position regardless of American policy or considerations of what constitutes a logical approach to assuring competitive behavior.[41] The attitude of the European regulators in two situations is revealing. In the proposed

GE-Honeywell merger, companies headquartered in the U.S. were approved to proceed by the American regulators while the Europeans disapproved.[42]

In the Microsoft case (see the discussion in Chapter 2), the second U.S. district court resolved the case with minimal penalties, while the EU has pursued significantly more stringent remedies.[43] The situation continues to unfold, with recent testimony from both sides to the European Court of First Instance to the effect that portions of the European Commission's remedy announced have been a complete failure. Microsoft was ordered to remove its Media Player from Windows XP but has seen almost no computer manufacturer or consumer interest in the resulting product. Microsoft continues to challenge the requirement that it disclose technical information to competitors on the grounds that this would breach its rights to valuable intellectual property.[44]

ANTITRUST IN JAPAN

Following World War II, the American occupying authorities ordered General Douglas MacArthur to end the zaibatsu, or cartels, which had controlled Japan's economy before the war.[45] The U.S. Departments of State and Justice, supported by President Truman, determined that these cartels had been strong supporters of the militaristic prewar government and major beneficiaries of war-related industrial production and that they prevented the formation of a middle class that was an essential requirement of a peacetime economy.[46] Although MacArthur feared the possibility that this action would destabilize the postwar recovery, he eventually agreed to demand that the Diet (parliament) pass a weak law on competition.[47] As a result, the zaibatsu were simply replaced by the keiretsu, large companies that practiced cooperation through cross-shareholding to dominate the Japanese economy in the years after the war.

The Antimonopoly Act (AMA)[48] followed American legislative

experience and created a Japan Fair Trade Commission (JFTC) with weak enforcement powers (as was likely MacArthur's intention). The early years saw few actions against business, and policy was reversed in the 1950s when the Western allies saw the Soviet threat to the Pacific region as a reason to develop an economically strong ally. The result was weak antitrust policy, which continued for the next four decades.

From the period of rebuilding and growth, beginning in about 1950 and continuing through the mid-1980s, the Japanese economy experienced growth rates of about10 percent a year. It became common wisdom in the West that Japan would become a serious rival to the U.S.. However, various scandals, poor investment decisions, questionable lending practices, and the inevitability of the business cycle led to an end to Japanese prosperity.[49] By the beginning of the 1990s, the economy fell into a deep recession that may be finally ending in 2007 Symptoms have included massive deflation; a drop in the Nikkei stock index from 39,000 to 11,000 (now nearly 17,000 late in 2007); a continuous decline in land prices in large cities; and the growth of government debt to 170 percent of gross domestic product (as compared with 50 percent in the U.S.).

The JFTC is the sole agency that enforces antitrust. As it does not have cabinet rank, other agencies like the Ministry of Finance are perceived as more important with regard to economic policy. Typical regulatory functions are assigned to the agency, such as investigating suspected violations, holding hearings on these incidents, calculating damages to be paid to the government in satisfaction of illegal behavior, and notifying the public prosecutor of the JFTC's intention to bring criminal charges. Damages are assessed as "surcharges," the statutory procedure to seize unfair profits from offending companies. However, unlike in the U.S., the amount of damages is set by regulatory schedule and may be far below a company's actual anticompetitive gains.[50]

The relatively puny enforcement of antitrust in Japan can be attributed to three significant factors: the continuing dominance of the keiretsu, including the concept of interlocking ownership of industrial companies and banking; the mild enforcement procedures granted to the JFTC; and the cultural preference of Japanese society to avoid legal situations and litigation.[51] The recent recession has lessened the power of the keiretsu and has led to efforts by the Japanese government to increase efforts to bring real competition into the country.

Antitrust in Japan is globally perceived as largely ineffective, and the country is considered as one of the least hospitable to foreign business. Despite the recent recession, few specific measures have been pursued to encourage competition. Statements from government officials indicate official interest in the situation,[52] but many Western businesspeople continue to complain about closed markets and favoritism toward local companies.[53]

FINANCIAL SERVICES REGULATION IN BRITAIN

For much of their history, financial institutions in Great Britain relied on self-regulation and the potentially unpleasant result of official disapproval. The Bank of England's regulatory role was also as the central bank and lender of last resort. A more formal bank regulatory system was introduced in the Banking Act 1979, which was in turn replaced by a strengthened Banking Act 1987.[54] The insurance industry was largely controlled by Lloyd's of London, and although shaken by scandals in the 1970s, it continued to rely on self-regulation. This failed to prevent further scandals or the losses that came from a series of disasters in the 1980s.[55]

The moralistic regulatory approach of the London Stock Exchange was questioned after a series of scandals that began in the 1970s in the securities markets,[56] leading to corrective legislation in the form of the Financial Services

Act of 1986.[57] The legislation drew heavily from the SEC regulatory model in the U.S. and, among other things, eliminated fixed commissions. Furthermore, the separation of brokers and dealers was removed in favor of competing market makers.

Another series of scandals led to calls for further reform. These incidents included Robert Maxwell's problems, the BCCI debacle, and several insider trading cases. The crisis at Barings Bank then precipitated more legislation, which created the Financial Services Authority (FSA-UK) in 1997.[58] In 1998 the agency was given the authority to oversee the banks, taking that power away from the Bank of England, and it eventually became a governmental super regulator for the financial services, from securities, banking, and insurance.[59] The FSA-UK was also provided with expanded enforcement powers that included the right to bring actions against violators and impose sanctions.[60]

Several steps were taken to unify regulation. First, a single ombudsman was to be created by the agency to handle complaints by customers in all sectors of public finance, as opposed to the various hotlines and websites for federal and state agencies in the U.S.. The FSA-UK replaced six separate insurance funds with a single Financial Services Compensation Scheme ("FSCS"), which provides customers with compensation in the event of the insolvency of a financial service firm. This sharply contrasts with the U.S. system that spreads responsibility among the FDIC and separates funds for insurance companies, thrift institutions, credit unions, and pension funds.

The FSA-UK is also seeking publication of comparative information disclosure for a range of financial instruments that would allow more informed investment decisions. The agency assigned one office to develop policy on issues across all financial sectors to develop a common approach to risk and capital requirements. There has been no comparable effort in the U.S., where there are separate capital requirements for insurance companies, banks, broker-dealers, and commodities futures.

In developing its regulatory approach, the FSA-UK is focusing on high-risk firms while requiring other firms to report and to comply with standards of conduct stated in its rulebook. The agency, like the SEC, has placed heavy emphasis on the supervisory responsibilities of senior corporate managers and has begun a program of enforcement actions, imposing fines and banning the guilty from trading in London.

FINANCIAL SERVICES REGULATION IN JAPAN

As noted in the section on antitrust in Japan, General MacArthur demanded changes to various Japanese laws and business practices, including laws on antitrust and on financial services. A Securities Commission for the Supervision of the Securities Business was established by law, largely derived from the American SEC.[61] Banks became members of the keiretsu, described earlier, and the central bank became the Bank of Japan while the Ministry of Finance managed financial policy.

Unlike the relative balance of policymaking through the Congress, the President, and the Federal Reserve, the Japanese Ministry of Finance became the dominant component of financial planning and regulation, leaving only a limited role to the Bank of Japan and abandoning aspects of the MacArthur-era attempt at opening markets to Western capitalism. The financial exchanges and the Japanese Securities Dealers Association also provided some minimal regulatory oversight.[62]

However, poor bank lending and investment practices and the extended economic recession beginning in the late 1980s led to serious crises in financial services. Most of Japan's largest banks have had capital shortages that compromise their ability to meet the Basel Committee's guidelines for international banks.[63] Yamaichi Securities, the fourth largest securities firm in Japan, failed and for a time was supported by the Bank of Japan and later purchased by Merrill Lynch.

To deal with this situation, various steps were taken. The Japanese Diet (parliament) enacted the Financial Reform Act of 1992, which authorized the establishment of capital requirements for banks and created a Securities Exchange and Surveillance Commission (SESC) as the regulator of the securities markets. An attempt at further reform occurred in 1996 through a "Japanese Big Bang" (similar to the earlier ones in the U.S. and UK) that deregulated Japan's financial services. The plan allowed banks, insurance companies, and brokerage firms to compete with each other without the restrictions that had kept these activities separate.[64] The government also announced a plan to deal with the massive amount of nonperforming debt in the economy and to dissolve bankrupt companies.

In 2000, the SESC and other supervisory agencies were succeeded by the Financial Services Agency (FSA-Japan).[65] Some concern has been expressed that all of these reforms may not have accomplished very much. FSA-Japan lacks strong enforcement mechanisms and is only an investigative agency with no authority to impose sanctions. When FSA-Japan has attempted to take aggressive action by suggesting bad debt write-offs, many medium-sized and smaller companies went bankrupt. Various large banks were supported by the government, and the Long-Term Credit Bank of Japan and the Nippon Credit Bank were nationalized after these institutions could no longer be kept afloat.

Significant problems continue in monitoring the behavior of financial securities companies. For example, Japanese legislators are demanding stricter monitoring over stock trading after the head of Internet startup Livedoor was arrested on suspicion of violating securities laws. The Livedoor situation has led to calls for the creation of a regulator with powers equivalent to those in the American SEC, particularly due to a major Tokyo stock market sell-off,in January 2006. Prosecutors have charged the chief executive officer Takafumi Horie with violations of various securities laws including spreading false information.[66]

On a positive note, the agency has been seeking greater public disclosures from firms with difficult financial circumstances. It raised its bank capital adequacy threshold for intervention and correction, although Japanese banks are still well below the Basel minimum international standard.[67] FSA-Japan increased regulatory controls over the insurance industry following some well-publicized insurance firm failures. Barriers to entry are being reduced, allowing some foreign competition in insurance.

WHAT THE U.S. SHOULD DO

Business regulation has followed various routes over the centuries, from a policy of lax enforcement (Japan) to official displeasure (Great Britain) through a review of potential offenders (the U.S.) through stringent restraint (the European Union). Interestingly, the general concept of regulation seems largely to be a creature of U.S. experience as exported to our allies and competitors.[68] However, the American requirement to set limits on the behavior of business has diminished as economic emergencies have ended, and this country finds itself in the difficult position of trying to compete in the global economy. The only appropriate regulatory model appears to be the British FSA, which has taken a consolidated approach to financial services, focusing on risky situations that could lead to systemic failure.

The U.S. and Japan are largely unsuccessful when considering the requirements of twenty-first-century business, while European regulators appear to have lost touch with the idea of sensible remedies for problems in commerce. This issue has reached a critical moment with the merger of the NYSE and Euronext, as there is no formal mechanism for monitoring exchanges that cross national boundaries. While there will be a greater sharing of information among officials of governments and exchanges, companies that

are publicly traded will use “regulatory arbitrage” to seek the least intrusive opportunities to raise capital.[69] In sum, nothing from international experience changes the conclusions reached in Part I that the U.S. should end all business regulation except for protections for consumers and the environment.

ENDNOTES FOR CHAPTER 7

(Endnotes)

[1] The Federalist Papers comprise a series of articles written by Alexander Hamilton, James Madison, and John Jay and are generally considered to be the definitive source for the ideas in the U.S. Constitution. The powers of the various branches of government are discussed in several papers: those of the President in Nos. 67, 69-70, and 76-77; those of the Senate in Nos. 62–65; and those of the House of Representatives in Nos. 52-53. The concept of a "temporary" situation in government did occur to the founders, and that term appears in Nos. 10, 27, 34, 38, 55, 57-59, 63, 67, 68, 71-72, 78, 81, and 84-85. However, the references are to such issues as presidential appointments, the number of representatives in the House, and the terms of judges. Searches are available at www.yale.edu/lawweb/avalon/federal/fed.htm.

[2] Interstate Commerce Act, ch. 104, 24 Stat. 379 (1887). Originally codified as amended in scattered sections of 49 U.S.C.

[3] The Motor Carrier Act of 1935 added bus and trucking companies to the jurisdiction of the Interstate Commerce Commission. Act of August 9, 1935, ch. 498, 49 Stat. 453. Another impetus for this legislation was the decision of the Supreme Court in Buck v. Kuykendall, effectively eliminating state regulation of such transportation modes in interstate commerce; 267 U.S. 307, 315 (1925).

[4] The interested reader should consult Jeffry A. Frieden, Global Capitalism: Its Fall and Rise in the Twentieth Century (2006), Chapters 9 and 10, which discuss autarky and social democracy during the 1930s. ("Autarky" is the philosophy of economic self-sufficiency and was practiced by the Third Reich in Germany and by Stalin's Soviet Union.)

[5] Public Law 73-316, 48 Stat. 943 (1934). For a review of this development, see Kenneth W. Dam, "Cordell Hull, the Reciprocal Trade Agreements Act, and the WTO," 1 NYU Journal of Law & Business 709 (2005).

[6] A protectionist Congress passed the Smoot-Hartley Tariff, Public Law 71-361, 46 Stat. 590 (1930), originally codified at 19 U.S.C. 1307. U.S. producers were shielded from importer competition, but other countries enacted retaliatory tariffs, aggravating the worldwide depression. For further information, see Stephen D. Cohen, Joel R. Paul, and Robert A. Blecker, Fundamentals of U.S. Foreign Trade Policy: Economics, Politics, Laws and Issues 32-33 (1996).

[7] These and other agencies are described in an outstanding history of FDR's Administrations by Arthur M. Schlesinger, Jr., The Age of Roosevelt. See Volume 2, The Coming of the New Deal (1959), and Volume 3, The Politics of Upheaval (1960).

[8] For a brief history of presidential attempts to influence the regulatory agencies, see Angel M. Moreno, "Presidential Coordination of the Independent Regulatory Process," 8 Administrative Law Journal 461, 481-86 (1994).

[9] 295 U.S. 602 (1935).

[10] Ibid., at 628. FDR was prevented from removing an FTC commissioner on the grounds of policy differences with the President as the agency was not a part of the executive department.

[11] See, e.g., Peter P. Swire, "Note: Incorporation of Independent Agencies into the Executive Branch," 94 Yale Law Journal 1766 (1985).

[12] See, e.g., Harold H. Bruff, "Presidential Management of Agency Rulemaking," 57 George Washington Law Review 533 (1989).

[13] Moreno, reference in note 8, at 484.

[14] For a discussion of Landis's career, see Donald Ritchie, James M. Landis: Dean of the Regulators (1980).

[15] An entertaining history of this incident and the entire period is John Brooks, Once in Golconda: A True Drama of Wall Street, 1920–1938 (1999).

[16] James M. Landis, The Administrative Process (1938), 1-24. See also Daniel Yergin and Joseph Stanislaw, The Commanding Heights (1998), particularly Chapter 2.

[17] The interested reader may wish to review Peter H. Aranson, Ernest Gellhorn, and Glen O. Robinson, "A Theory of Legislative Delegation," 68 Cornell Law Review 1 (1982).

[18] For information on the Brownlow Committee, see Herbert Emmerich, Federal Organization and Administrative Management 46-61 (1971).

[19] Robert E. Cushman, "The Problem of the Independent Regulatory Commissions," reprinted in The President's Committee on Administrative Management, Report of the Committee with Studies of Administrative Management in the Federal Government 32 (1937).

[20] Reorganization Act of 1939, Public Law 76-19, ch. 36, 53 Stat. 561 (1939) (repealed).

[21] Commission on Organization of the Executive Branch of Government, Public Law 80-162, ch. 207, 61 Stat. 246 (1947); a report on regulatory commissions was submitted to Congress on March 3, 1949.

[22] Commission on Organization of the Executive Branch of Government, Public Law 108-93, ch. 184, 67 Stat. 142 (1953) (repealed).

[23] Kennedy: Staff of Senate Committee on the Judiciary, 86th Cong., 2d Sess., Report on Regulatory Agencies to the President-elect (1960). Ford: Senate Comm. on Government Operations, Study on Federal Regulation, S. Doc. No. 95-26, 95th Cong., 1st Sess. (1977).

[24] This point is discussed in some detail in Alfred C. Aman, Jr., "Administrative Law in a Global Era: Progress, Deregulatory Change, and the Rise of the Administrative Presidency," 73 Cornell Law Review 1101, 1192-1209 (1988).

[25] This discussion is based on Joseph D. Kearney and Thomas W. Merrill, "The Great Transformation of Regulated Industries Law," 98 Columbia Law Review 1323, 1330-50 (1998).

[26] Marginal cost is the cost of providing one additional product or service. In contrast, many business decisions are based on average cost, which is the total of all fixed and variable costs divided by the number of units supplied to the market. Economic theory believes that each has its place in pricing: average cost to formulate long-term marketing and production strategy, and marginal cost to determine the price to be charged once commitments have been made to incur such fixed costs as the acquisition of plant and equipment. An example of a cross-subsidy is the business flyer who pays more than the vacationer for the same airline seat.

[27] In March 2006 alone, AT&T announced its intention to merge with BellSouth, while Verizon intends to complete its ownership of Verizon Wireless. See Ken Belson and Geraldine Fabrikant, "Those Bell Mergers Are Giving Cable Companies Even More to Worry About," New York Times, March 13, 2006, at www.nytimes.com/2006/03/13/business/13cable.html?adxnnl=1&adxnnlx=1142538014-ac6PlZyEsrGiVT/5+LDvTA.

[28] "Piggybacking" is the practice of carrying trailers, semi-trailers, or containers in a flatcar atop a train.

[29] See Marcus Alexis, "The Political Economy of Federal Regulation of Surface Transportation," in The Political Economy of Deregulation: Interest Groups in the Regulatory Process 115 (Roger G. Noll and Brice M. Owen, eds., 1983).

[30] See G. Kent Woodman and Jane Sutter Starke, "The Competitive Access Debate: A 'Backdoor' Approach to Rate Regulation," 16 Transportation Law Journal 263, 266-67 (1988).

[31] In order to restore the health of the industry, Congress passed the Regional Rail Reorganization [3R] Act of 1973, 45 U.S.C. 719 (1973); the Rail Road Revitalization and Reform [4R] Act of 1976, 45 U.S.C. 801 (1976); and the Staggers Rail Act of 1980, 49 U.S.C. 10101 (1980).

[32] Modification of Final Judgment IIA, reprinted in U.S. v. AT&T, 552 F.Supp. 131 (1982), aff'd mem. sub nom. Maryland v. U.S., 460 U.S. 1001 (1983).

[33] See Mary Lu Carnevale, "Baby Bells Grow Up," Wall Street Journal, November 9, 1990, R46; and Frances Seghers, "The Baby Bells Become Problem Children for AT&T," Business Week, January 18, 1988, 60. These articles describe the RBOCs'

efforts to have line-of-business restrictions removed.

[34] Public Law 104-104, 110 Stat. 56 (1996), codified at scattered sections of 47 U.S.C.

[35] Public Law 102-486, 106 Stat. 2776 (1992), codified at 42 USC 2296a- 1 et seq.

[36] Winston Churchill was one of the few statesmen who called for a "U.S. of Europe," a federation of European states to promote harmonious relations among nations, economic cooperation, and a sense of European identity. Churchill argued that a united Europe was the best means to heal residual hatred from the war, although he did not envision Great Britain as a member. See Wendell Mauter, "Churchill and the Unification of Europe," in 61 The Historian 67 (1998).

[37] Treaty Establishing the European Community, March 25, 1957. The treaty is available at www.hri.org/docs/Rome57. For additional information, see www.historiasiglo20.org/europe/traroma.htm.

[38] Ibid., articles 85-94.

[39] See Valentine Korah, An Introductory Guide to EC Competition Law and Practice (6th edition, 1997).

[40] For explanations of the laws of the major European countries, see American Bar Association Section of Antitrust Law, Competition Laws Outside the U.S. (2001). The EU antitrust agency is the European Commission for Competition Policy.

[41] For commentary along these lines, see Fred S. McChesney, "Talking 'Bout My Antitrust Generation: Competition for and in the Field of Competition Law," 52

Emory Law Journal 1401 (2003). For a European view of the need for strong enforcement, see Hugo Paemen (then Ambassador of the European Commission to the U.S.), "Trade and Competition in the Transatlantic Area," 21 Fordham International Law Journal 637 (1998).

[42] See Robert J. Reynolds and Janusz A. Ordover, "Archimedean Leveraging and the GE/Honeywell Transaction," 70 Antitrust Law Journal 171 (2001).

[43] The European Commission claims that Microsoft is not in compliance with its antitrust ruling and has been threatening to fine the company as much as 2 million euros ($2.4 million) a day. Microsoft paid 497 million euros in fines in 2004. See, e.g., Paul Meller, "In Europe, Microsoft Faces a New Antitrust Complaint," New York Times, February 23, 2006, at select.nytimes.com/search/restricted/article?res=F00B12FA355A0C708EDDAB0894DE404482.

[44] See Paul Meller, "Microsoft in European Court Says 2004 Ruling Is a Failure," New York Times, April 26, 2006, C6.

[45] Gregory D. Ruback, "Comment, Master of Puppets: How Japan's Ministry of Finance Orchestrates Its Own Reformation," 22 Fordham International Law Journal 185, 189-90 (1998).

[46] See Alex Y. Seita and Jiro Tamura, "The Historical Background of Japan's Antimonopoly Law," 1994 University of Illinois Law Review 115, 148-49 (1994).

[47] It should be recalled that MacArthur expected to be nominated for President in 1952 and did not want any controversy to reflect on his peacetime role as Supreme Allied Commander in the Pacific. For a review of MacArthur's career, see William Manchester, American Caesar (1978).

[48] The formal name is the Antimonopoly and Maintenance of Fair Trade Act, Law No. 54 of 1947. For a review of Japanese antitrust, see James D. Fry, "Note: Struggling to Teethe: Japan's Antitrust Enforcement Regime," 32 Law and Policy in International Business 825 (2001); and Shigeki Kusunoki, "Shaping an Anti-Monopoly Law Sanction Regime against Cartels or Bid Collusion: A Perspective on Japan's Choice," 79 University of Detroit Mercy Law Review 399 (2002).

[49] See Dafei Chen, "Acute Symptoms of Chronic Problems: Japan's Procrastination in Solving Its Bank Crisis, the Current Situation and a Future Perspective," 9 Minnesota Journal of Global Trade 269 (2000).

[50] For a brief explanation of the surcharge system, see Fry, reference in note 48, at 838-41.

[51] On this latter point, see Gino Dal Pont, "The Social Status of the Legal Professions in Japan and the U.S.: A Structural and Cultural Analysis," 72 University of Detroit Mercy Law Review 291 (1995). However, there are reports that Japanese companies are becoming more litigious, particularly in international business matters. See, e.g., Ian Rowley and Kenji Hall, "Japan: Lawyers Wanted. No, Really," Business Week, April 3, 2006, 46.

[52] See, e.g., the statement of Prime Minister Koizumi that the power of the JFTC should be expanded; Kusunoki, reference in note 48, at 412; and the statement by JFTC Commissioner Itoda that the agency "barks loudly and bites violators hard"; Fry, reference in note 48, at 825.

[53] See, e.g., Todd Zaun, "Japan Aims to Stiffen Antitrust Penalties," New York Times, June 30, 2004, at select.nytimes.com/search/restricted/article? res=FA0B10F63E 5C0C738FDDAF0894DC404482. This article contains the following statement:

"Although Japanese antitrust laws are based on U.S. laws, Japan's competition watchdog has long been criticized for lacking the kind of bite regulators in the U.S. have. Illegal cartels and bid rigging have been common in Japan … but violators have almost never faced criminal prosecution and fines are typically less than half of those levied for similar violations in the U.S. and Europe."

[54] See Heidi Mandanis Schooner and Michael Taylor, "Convergence and Competition: The Case of Bank Regulation in Britain and the U.S.," 20 Michigan Journal of International Law 595, 629-35 (1999); and Philip N. Hablutzel, "A Legal Sampler: British Banks' Role in U.K. Capital Markets Since the Big Bang," 68 Chicago-Kent Law Review 365 (1992).

[55] Ian Kelley, "Note: Regulatory Crisis at Lloyd's of London: Reform from Within," 18 Fordham International Law Journal 1924 (1995).

[56] For a description of the London financial markets, see David Kynaston, The City of London (1994).

[57] The legislation also created a Securities and Investment Board (SIB) that reported to the Department of Trade and Industry, although it had no enforcement powers. The SIB proved to be a reluctant and ineffective regulator.

[58] Thomas Sims, "Single Regulators Are Catching on in Europe," Wall Street Journal (International), March 6, 2001, A14.

[59] The functioning of the agency is described in FSA, Introduction to the Financial Services Authority (2001).

[60] See, e.g., Silvia Ascarelli, "Deals & Deal Makers: New U.K. Financial Regulator Draws Fire," Wall Street Journal, May 30, 2001, C16.

[61] For a background on post–World War II securities and banking regulation including the Japanese Securities and Exchange Law, see Hideki Kanda, "Securitization in Japan," 8 Duke Journal of Comparative and International Law 359 (1998).

[62] A useful overview is in Andrew M. Pardieck, "The Formation and Transformation of Securities Law in Japan: From the Bubble to the Big Bang," 19 UCLA Pacific Basin Law Journal 1 (2001).

[63] The Basel Committee issues capital requirements for bank exposures to certain trading-related activities, including counterparty credit risk, and for the treatment of double default effects, or the risk that both a borrower and guarantor default on the same obligation; see bis.org/publ/bcbsca.htm.

[64] See Jessica C. Wiley, "Note: Will the 'Bang' Mean 'Big' Changes to Japanese Financial Laws," 22 Hastings International and Comparative Law Review 379 (1999).

[65] Web sites with current information include fsa.go.jp and fsa.go.jp.

[66] "Japan Calls for Stricter Market Monitoring," New York Times, January 26, 2006; at nytimes.com/aponline/business/AP-Japan-Livedoor.html?_r=1.

[67] Within recent years, large Japanese banks had capital of about one-fourth of that required by the Basel standard. "Hampered," The Economist, July 13, 2002; at economist.com/displaystory.cfm?story_id=E1_TNNQRGT.

[68] According to David Vogel, British regulation predates U.S. regulation. The first law, passed in 1853, attempted to control the smoke emitted by coal furnaces. See

National Styles of Business Regulation (2003 edition), Chapter 1.

[69] These issues are noted in Bernard Wysocki, Jr., and Aaron Lucchetti, "Global Exchanges Pose a Quandary for Securities Cops," Wall Street Journal, June 5, 2006, A1.

CHAPTER 8: ESSENTIAL GLOBAL REGULATION – THE FINANCIAL MARKETS

This is the grass that grows wherever the land is and the water is,
This is the common air that bathes the globe.
Walt Whitman (1819–1892), "Song of Myself"

In Chapter 7 we reviewed some of the history and outcomes attributable to regulation in the U.S. and in other developed economies. Included in the discussion was the current role of the European Union in antitrust, which is an interesting situation where a regional economy has largely preempted the oversight responsibilities of its member nations. Some observers have begun to seriously consider the ramifications of this "weakening" of national sovereignty and how the rule of law, particularly business law and regulation, may be affected in the future.[1] This chapter examines the sovereignty issue with regard to the regulation of business and then considers international arrangements that are providing governance in the situation of the financial services industries.

SOVEREIGNTY AND INTERNATIONALISM

The territorial boundary is a basic premise of law that enables governments to define appropriate conduct within its defined area.[2] Affairs between countries have historically been managed by treaties and agreements, sometimes involving multiple signatories and sometimes only a few, sometimes reached openly and sometimes secretly, but inevitably based on the concept of a community of sovereign states. However, the system of national sovereignty failed to prevent international crises by early in the twentieth century, and President Woodrow Wilson and other world leaders decided to initiate the formation of new procedures to mediate global problems.

A WORLD VIEW BECOMES A NECESSITY

The creation of the League of Nations and its rejection by the U.S. Senate is a story too well known to justify retelling here.[3] Following the hostilities of World War II and to honor the memory of President Franklin Roosevelt, the allies formed the United Nations (UN), a permanent institution to resolve global conflicts. Other transnational organizations created at about that time included the International Monetary Fund (IMF) in 1944, the World Bank in 1944, the North Atlantic Treaty Organization (NATO) in 1949, and the European Coal and Steel Community in 1951, the predecessor of the European Union; see Figure 8-1 for an explanation of the activities of various political and economic agencies created as a result of World Wars I and II.

Figure 8-1:
International Organizations

Name	Date Created	Purpose
Global Banking Organizations		
Bank for International Settlements (BIS)	1930*	Fosters cooperation among central banks, international financial institutions, and governments
International Monetary Fund (IMF)	1944	Fosters stable foreign exchange arrangements; supports balance-of-payments equilibria; assists countries experiencing financial crises
World Bank	1944	Provides loans and grants to developing countries to enable development of infrastructure
Organization for Economic Cooperation and Development (OECD) (preceded by the Organization for European Economic Co-operation in 1947)	1961	Promotes economic development among member nations; develops model legislation on international trade
World Trade Organization (WTO) (preceded by the General Agreement on Tariffs and Trade in 1947)	1995	Negotiates reduction and elimination of tariffs and other trade barriers; mediates trade disputes

Name	Date Created	Purpose
Regional Economies		
Association of Southeast Asian Nations (ASEAN)	1967	Promotes economic growth among member nations; expects China to join
European Union (EU) (preceded by the European Coal and Steel Community in 1951 and the European Economic Community in 1958)	1994	Establishes economic policy for member nations; abolished trade barriers; operates central bank (except for non-euro countries)
North American Free Trade Agreement (NAFTA)	1994	Operates free trade area among member nations
Other		
North Atlantic Treaty Organization (NATO)	1949	Assures military security of member nations

The U.S. became a member in 1994.

The defining event that imposed control by these and other organizations was almost certainly World War II. Americans can probably appreciate the global demand for improved international problem-solving mechanisms, but it is only those countries that experienced years of war's devastation on their own soil that could not imagine reverting to the older, failed system of national sovereignty and international alliances. To the credit of the U.S. and driven

largely by fear of the Soviet Union, the American tradition of isolationism was effectively replaced by global activism.

Some of the decisions led to happy results, for example, the work of certain UN agencies such as UNESCO; and some resulted in tragic outcomes, for example, the SEATO pact which ultimately led to the American involvement in Vietnam.[4] As the U.S. and other countries have progressed through the past half century, the successful international organizations have gained important positions of oversight, significantly improving the prospects for peace and economic security.

It is remarkable that these organizations have largely overcome past mistakes and inept decision-making. For example, the IMF has learned a great deal about developing country loans and has moved away from requiring stringent austerity measures as a condition for funding.[5] The UN has made various errors in managing its numerous programs, but seems to be learning from its mistakes and now appears to be functioning more efficiently.[6] The WTO has been made to understand the necessity for providing a forum for the demands of poorer countries, and although the lesson was taught through violent protests, its discussions now extend beyond tariffs and trade barriers.[7]

NATIONAL INTERESTS AND TWENTY-FIRST-CENTURY REALITIES

Despite movement toward international business regulation, existing nation-state legislation remains, largely outdated and ineffective. It disregards the realities of global competition; the fact of free trade and people movement in the nations of the EU; the ascendancy of the multinational corporation; technological advances in computers, telecommunications, and e-commerce; international capital flows; and other dynamic changes in the twenty-first-century economic structure. It further ignores the process of cooperation, bargaining, and partnering that must and does occur to achieve important goals, including the convergence of policies toward accepted outcomes regarding the environment, health issues, protection of human rights, and other basic global expectations.[8]

As Part I of this book explains, business regulation is not required in most situations, and substituting bureaucratic decision-making for the market economy inevitably leads to poorer results. In traditional concepts of regulation, decisions are based on narrow industry definitions and vague statutes that are subject to judicial interpretation following years of litigation. For those businesses where such control is deemed essential, the complexity and speed of today's economic environment require a dynamic, global approach to oversight.

THE SPECIAL CASE OF THE FINANCIAL MARKETS

The financial markets are among the most significant sectors requiring regulation because of their fiduciary role[9] and the potential for the failure of the economic system (often referred to as systemic failure). Therefore, we next turn to a review of global (vs. national) actions to stabilize banking and the securities markets. The concept of free markets and an unrestricted flow of capital in global markets must be tempered by concern for the crises that have occurred throughout the world in recent decades, from South America to Southeast Asia. Countries are increasingly at the mercy of global financial markets, yet many observers complain that little has been done to strengthen international economic institutions.[10] Suggested "fixes" range from incremental to significant reforms, including those made by several national governments and international committees. Some of these proposals are contradictory and mutually incompatible:

- Liberalization of international capital markets or the imposition of capital controls

- Greater exchange rate flexibility or the reestablishment of stable, even fixed, rates between currencies
- More forceful responses by the international community to economic crises or a laissez-faire approach to economic crises
- Revisions to the mission of the International Monetary Fund (IMF) through more funding and charter and governance changes, or the creation of a super-world central bank like the European Central Bank or the Federal Reserve with powers to root out corruption and compel countries to install the institutional prerequisites for stable financial markets

ASSUMPTIONS ABOUT THE GLOBAL FINANCIAL SYSTEM

Five assumptions are made concerning the operation of the international financial system:

1. The Deregulation of Financial Markets. Global financial markets should continue to deregulate while encouraging prudent lending and investing decisions. The actions of open markets support savings and efficient investment allocation while allowing rational consumption decisions and portfolio diversification. In the past, developing countries and banks often stifled financial transactions and directed credit decisions to unfortunate outcomes.

2. The Global Mobility of Capital. International financial liberalization and growth in the flow of capital are inevitable and irreversible. Domestic

and international capital flows are being driven by powerful changes in information and communications technologies that make restrictions on financial transactions unlikely to succeed.

3. The Dissemination of Capital Market Information. Although the efficient market hypothesis would conclude otherwise,[11] imperfect distribution of information can give rise to overshooting and sharp corrections. Some of the relevant "data," such as whether a government will follow through on reform and maintain its commitment to monetary and fiscal discipline, are unavoidably based on opinion and conjecture as much as hard evidence. This encourages investors to draw inferences from one another's actions and to move in a herd.

4. Financial Market Safeguards. A system of market guarantees is essential despite the moral hazard that may result.[12] History shows the need for deposit insurance and a lender of last resort to contain systemic risks to financial systems; see Chapter 3. To be sure, provision of this safety net encourages market participants to take on additional risk, heightening the need for vigorous supervision and regulation of the recipient institutions.

5. Where Economics Meets Politics. Economic policy is framed in a political environment. It cannot be assumed that regulators and other economic policymakers will carry out their tasks without allowing themselves to be influenced by political considerations. To the contrary, lobbying and pressure politics inevitably shape the policies that are pursued. Realistic strategies require acknowledging these pressures and not assuming that policymaking institutions such as the lMF can be made to follow rigid apolitical rules.

INTERNATIONAL BANKING

The Bank for International Settlements (BIS) provides a venue for national bank supervisors and regulators to pool their expertise and develop international standards for bank regulation. Prompted primarily by the failure of the Herstatt Bank,[13] the Basel Committee of the BIS (consisting of representatives from the bank supervisory authorities of the major industrial countries) began in 1975 to develop the Basel Capital Accord (Basel I), which was eventually adopted in 1988. International bank signatories agreed to hold their institutions to minimal capital requirements of 8 percent of risk-weighted assets.

BASEL I AND II

The 1995 Market Risk Amendment permitted banks to use their proprietary models to calculate correlations among and within broad risk categories (such as interest rate risk, exchange rate risk, and equity price risk) in order to come up with more economically sophisticated risk weights, and the 1997 Core Principles for surveillance of banking and financial systems identify five categories of standards for sound supervision and regulation. The weight for each class of asset ranges from zero (for assets thought to be very safe, such as the government debt of developed countries) to 100 percent (for unsecured loans to consumers and companies). In practice, the rules vary slightly across countries: in Japan, for example, shares in other firms can be counted as capital, and the minimum capital ratio for banks that are not internationally active is only 4 percent.

The capital of American banks is now 13 percent of risk-weighted assets, up from 10 percent in 1990 (vs. the Basel minimum of 8 percent). Banks have improved their risk management partly by passing credit and market risks on to other parts of the financial system, such as other banks, insurers, pension funds, and hedge funds. These recipients have been perfectly happy to accept those risks, and many of them even understood what they were doing. These transfers are through various derivative instruments (such as calls, puts, and swaps) and by the outright sale of assets.

However, U.S. and international financial regulators worry that they can no longer see where risks end up. When the tech-stock bubble burst in 2000–2001 and America's economy turned down, no one really knew what had happened to the risks that would once have been borne mainly by banks. The best guess is that the pain was spread broadly across the financial system, with no single big institution bearing a dangerously large share of the burden, which is what derivatives are supposed to do.

The Basel I rules changed in 2007 with a new accord, Basel II.[14] By the turn of the millennium, big banks' risk-management systems became far more sophisticated than required under Basel I. Moreover, Basel I had an unintended consequence: its weights did not match the market assessment of the risks that banks faced. As a result, banks indulged in regulatory arbitrage,[15] disposing of risks for which Basel I required more capital than the market did, such as credit-card debt or residential mortgages, and retaining assets for which the market demanded more capital than the regulators did. The rise in banks' capital-adequacy ratios reflects this process as well as better risk management. Basel II is intended to bring regulatory capital requirements more into line with actual risk and to reflect improvements in the best banks' practices. Banks will use complex mathematical models to evaluate the necessary cushion to avoid financial market shocks.[16]

THE CURRENT BANKING ENVIRONMENT

Banks have become more resilient to unexpected economic or credit problems. These days they are a much less important source of corporate finance than they used to be, so they are less exposed to a downturn in the economy. In America, the largest financial institutions now supply 20 percent less of the money that companies raise each year than just a decade ago and far less than in other countries.[17] Bigger companies are increasingly likely to tap the capital markets, which are far deeper in the U.S. than in Europe or Asia. Much of American banks' recent success is due to their increased ability at managing this basic function of transferring capital from savers to borrowers. However, figures from the Federal Reserve show that large banks began tightening their credit standards and imposing more stringent terms well before the start of the most recent recession.[18]

As well as improving their reading of the economic forecasting, banks have become adept at diffusing the risk of their loans through a variety of risk management techniques. Mortgages, for example, are often securitized,[19] taking them off the books of the originating banks. The repeal of laws restricting banks' geographic movement (the Riegle-Neal Act of 1994) has allowed them to enter every state, making them less exposed to local economic problems. The repeal of prohibitions on commercial and investment bank activity in the same institution (the Gramm-Leach-Bliley Act of 1999) has permitted the use of capital in profitable and potentially higher yielding activities.

CURRENT ACTIVITIES IN GLOBAL FINANCIAL CRISIS MANAGEMENT

Despite calls for change,[20] the current system of global regulation and control appears to be working. National governments and international financial institutions must continue to encourage the identification and adoption of international standards for minimally acceptable practice governing bank supervision and regulation, securities market operation and oversight, accounting and auditing practices, and insolvency or bankruptcy codes. International organizations are already active in a number of these areas to identify standards or to coordinate the process through which others agree to them; see Figure 8-2.

Figure 8-2:
Selected Oversight Activities of
Global Financial Markets

- **Access to capital markets**
  o A Special Data Dissemination Standard (established by the IMF) to provide economic and financial information by countries seeking to access international capital markets. A code of fiscal transparency has been promulgated to be adopted as a standard of good fiscal practice by its member countries, and it anticipates developing an accompanying code for monetary and financial practices; see www.dsbb.imf.org.

- **Accounting**
  o The International Accounting Standards Board consisting of representatives of the accounting profession from more than 100 countries to promulgate international accounting standards; see www.iasb.org.

  o The International Federation of Accountants (see www.ifac.org) and the International Organization of Supreme Audit Institutions (see www.intosai.org) to formulate international auditing standards.

  o The Public Company Accounting Oversight Board, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and the public interest; see www.pcaobus.org.

- **Bankruptcy**
  o Committee J of the International Bar Association to develop a model insolvency code to guide countries seeking to reform and update their bankruptcy laws; see www.ibanet.org/committees/SBL-Jsubs2.asp.

  o The United Nations Commission on International Trade Law (UNCITRAL) has adopted a model law on the treatment of cross-border insolvencies; see www.uncitral.org.

- **Corporate governance**
  o The Organization for Economic Cooperation and Development (OECD) reported on global principles of corporate governance, focusing on the accountability of management, disclosure and transparency, and communication with shareholders; see www.oecd.org.‡

  o The International Corporate Governance Network (ICGN) to improve global standards of business management and accountability; see www.icgn.org.

  o The Cadbury Committee on Corporate Governance to require companies listed on the London Stock Exchange to state in their accounts whether or not the code had been followed; see www.indiainfoline.com/nevi/cadb.html.

- **Global macroeconomic issues**
  o Group of Eight (G-8) or Group of Seven (G-7)

- **Securities markets**
  o Securities and Exchange Commission (U.S.)

  o Committee of European Securities Regulators (Europe)

‡Organization for Economic Cooperation and Development, Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets, Paris, 1998.

FORECASTING A CRISIS

The prevention of a future financial crisis is a critical element in global financial regulation. Such a crisis could occur in various forms.

- Some countries will continue to experience old-fashioned balance-of-payments crises as a result of pursuing excessively expansionary monetary and fiscal policies that are incompatible with their exchange rate commitments.[21] Their currencies will grow increasingly overvalued, their current-account deficits will widen, and their international reserves will fall to the danger point when a crisis erupts. Ironically, the country with the greatest exposure to this type of crisis is undoubtedly the U.S., with its 2006 current account deficit of about $725 billion![22]

- Other nations will experience crises driven by domestic financial-sector weaknesses and international capital flows. In those cases, a panic will erupt when investors lose confidence in the country's

banking system, stock market, or public debt management and when their scramble for the exits brings the financial system and the currency crashing down. As of early 2006, no country appeared to be in this situation; however, see the comments on past Mexican and South Korean crises in the sections that follow.

These occurrences often result from sudden reactions by market participants to new information or new interpretations of old information. Prevention could be accomplished by placing markets in a state-sponsored regulatory straitjacket. However, severe repression means forgoing the benefits of domestic financial liberalization and the suboptimal assignment of scarce factors of production. Mismanaged economies and the resulting financial crises are so destructive to capitalism that most countries and lenders are now behaving responsibly.[23] The unrealistic monetary or fiscal expansion or the loss of confidence in financial institutions could occur, but global discipline imposed by international agencies, lenders, and investors appear to be providing the constraints necessary for the avoidance of a major calamity.

REACTING TO CRISES

International capital mobility has all but erased the line between the domestic and international financial systems. This makes it impossible to "fix" the international economic system without also "fixing" the domestic financial system. As a result, retaining business confidence means assuring the stability of domestic financial systems through transparency in operations, adequate supervision and regulation of financial institutions, and appropriate auditing and accounting procedures.

In a crisis, the global community can either run to the rescue or stand aside:

- Run to the rescue of the country in crisis. For example, at the end of 1994, Mexico had $28 billion of short-term debt but only $6 billion of international reserves. Given the obvious inability to service its existing obligations, Mexico would either default, risking its global credit standing for decades, or have to find a willing angel. The U.S. realized that NAFTA and the economic (and possibly political) future of its southern neighbor would be jeopardized and arranged with the IMF for adequate credits to redeem maturing loans at full value.

  The situation in South Korea was similar, as the sudden realization in 1997 of the possibility of default caused foreign creditors to withdraw their deposits in South Korean banks. With the decline of reserves to about $5 billion below debt obligations, the U.S. and the IMF felt compelled to lend sufficient funds to stabilize the country's precarious financial situation. Geopolitics was a critical factor in the decision to support the country, particularly given the continuing threat from North Korea. Incidentally, following these two crises, the IMF was subjected to some criticism for bailing out governments and international investors.[24]

- Stand aside and let nature run its course. For example, in the summer of 1998, Russia devalued the ruble and suspended debt service payments, with devastating impacts on the Russian economy and global financial markets. Confidence was destroyed; the country's access to international capital markets was curtailed; and financial markets were roiled in East Asia, Eastern Europe, Latin America, and even Europe and the U.S.. However, no bailout occurred and the situation eventually settled down.

SUGGESTED BANKING CHANGES

The two remaining issues in managing global financial crises are discussed below: managing bankruptcies and managing the use of derivatives. Neither of these concerns is likely to cause a systemic risk, and both can be addressed through mechanisms that exist and are adaptable to the requirements of global financial systems.

MANAGING BANKRUPTCIES

A number of modest steps might realistically be taken to make international debt restructuring a viable option through practices that parallel those in the corporate debt markets. Majority voting and sharing clauses could be added to loan contracts. This would prevent isolated creditors from resorting to lawsuits and other means of obstructing settlements that improve the welfare of the debtor and the vast majority of creditors. Other desirable changes to loan contracts include collective representation clauses (making provision for an indentured trustee to represent and coordinate the creditors in the case of sovereign debts); and clauses providing that a minimum percentage of bondholders must agree for legal action to be taken.

The addition of such clauses to bond contracts is the only practical way of creating an environment conducive to flexible restructuring negotiations. It can be done by legislators and regulators in the U.S. and UK, the principal markets in which international bonds are issued and traded, without ceding any jurisdiction or authority to a global agency. This approach is infinitely more realistic than imagining the creation of some kind of world bankruptcy court for sovereign debts that is empowered to establish settlement terms.

MANAGING DERIVATIVE RISK

There has been a dramatic increase in the use of credit derivatives, especially credit-default swaps (insurance against the risk of default), which have been bought overwhelmingly by large international banks. In 2005, American banks held more than $500 billion of credit-default insurance; on the other side, they were guarantors of almost $400 billion-worth. Until the mid-1990s, this market barely existed. The effect of all this has been to reduce the impact of corporate defaults on the U.S. banking system.[25]

By early 2004, banks had more than $70 trillion worth of derivatives on their books,[26] which is twice the amount of five years ago. Much of the activity is designed to protect the value of the mortgages they hold. Although there has been ample evidence of the likelihood of rising interest rates, the concern is that derivatives could result in significant losses, particularly as these contracts take time to unwind. The 1994 increase in rates wreaked havoc on banks' securities holdings, incurring a significant loss in portfolio values.

Similar strains are starting to reappear, including the subprime credit crisis in mid-year 2007, although banks are loath to talk about their use of derivatives before they have to do so. Former Federal Reserve Chairman Greenspan argued that the widespread use of derivatives spreads risk among different market players, including nonfinancial companies, making the financial system a lot safer. All the same, Greenspan reminded banks that they need to keep pace with changes in the market and "readjust accordingly."[27] The Comptroller of the Currency and other regulators must keep a watchful eye on derivative positions, particularly in periods of interest rate (and foreign exchange) volatility.

SECURITIES MARKET OPERATION AND REGULATION

Changes in the legislative and regulatory oversight of global securities markets have actually been underway for some time. Beginning with the May Day 1975 ending of fixed brokerage commissions (see Chapter 4), the American markets have been forced to learn to compete with global, electronic markets through a variety of completed and contemplated actions. A partial list is summarized below; see Figure 8-3 for an explanation of these changes.

- Discount and Internet trading of securities for institutions and individuals
- Changes to clearing and settlement practices and timing
- A global shift to public ownership of stock exchanges
- The use of decimalization rather than fractions to make pricing fairer for buyers and sellers of stocks and bonds
- Changes to the executive management structure of the New York Stock Exchange (NYSE)
- Actions to end the specialist system at the NYSE
- Electronic order–matching for nearly all exchanges except the NYSE
- Movement toward de facto globalization of the securities markets

Figure 8-3:
Explanation of Changes to
Securities Market Operation and Regulation

Discount and Internet trading of securities for institutions and individuals.

May Day (May 1, 1975) ended the fixed commission system, allowing securities firms to charge any amount deemed reasonable to their clients. Several discount brokers then entered the business in competition with established, full-service broker-dealers, focusing primarily on retail customers (rather than institutional investors). With the advent of personal computer systems and the Internet, many of these discount brokers realized that trading costs would be greatly reduced through electronic data entry. As a result, commissions are a fraction of their pre–May Day cost, with some firms charging as low as $5 for a trade that may have originally cost hundreds of dollars. The lure of inexpensive, online trading has converted an estimated one-fifth of all stockholders to these types of accounts through the discount brokerage operations of banks and such firms as Charles Schwab, Datek, Ameritrade, and E*Trade.

Changes to clearing and settlement practices and timing.

Through the work of the Group of 30, securities markets have expedited the clearing and settling of investment transactions through global standardization and systematic reductions in the time to clear and settle trades.* Originally requiring five trading days to complete the recordkeeping and funding of a trade (known as "T+5"), the goal for the U.S. financial services industry is to settle all trades one day after trade date ("T+1") from the current "T+3." The move from

T+3 to T+1 reduces the settlement risk profile of the U.S. securities industry. In addition, T+1 will serve as a catalyst for changes in processing, thereby enabling the U.S. market to function effectively and maintain its competitive position. Finally, more streamlined processing will make it possible for the U.S. market to support daily trading volumes in the billions of shares.

The Securities Industry Association has developed a list of actions, or "building blocks," which are needed to achieve T+1. The ten building blocks are the minimum set of initiatives that need to be implemented to move from T+3 to T+1 processing. They include changes to regulation, information technology, organizations, and behaviors. Implementing the building blocks will streamline securities processing throughout the industry and result in substantially reduced error processing, reconciliation, and rework. In the end, it is the asset owners (the institutional and retail customers) who will benefit from reduced processing costs with T+1.

A global shift to public ownership of stock exchanges.

Stock exchanges around the world are converting from being member-owned cooperatives to being publicly traded firms. This shift reflects a variety of causes including greater access to capital, the need for greater efficiency in operation, and the increasing heterogeneity of members' interests leading to difficulties in cooperative decision-making. This change is both widespread and accelerating; eight of the world's ten largest stock markets are now publicly traded firms, with proposed conversions pending for several other markets. In 1995 there were no publicly traded exchanges; now there are twelve, with a market value approaching $25 billion. In the U.S., only the NASDAQ and the Chicago Mercantile Exchange currently have traded shares, although the Philadelphia Stock Exchange has announced plans to convert to public ownership.**

The use of decimalization rather than fractions to make pricing fairer for buyers and sellers of stocks and bonds.

In January 2001, the major U.S. exchanges switched trading to increments of one penny from fractions (□=12½¢; ¼=25¢; □=37½¢; ½=50¢; □=62½¢; ¾=75¢; □=87½¢; and for low-priced shares, sixteenths of a dollar were quoted). The SEC and congressional proponents of decimalization pushed the U.S. markets to drop their traditional fractional trading, in part so they would be up to speed with markets elsewhere in the world. Supporters of the change to decimals have said the new trading increments benefit investors by reducing the so-called spread, or the difference between the highest price buyers offer for a stock and the lowest price sellers ask.

Changes to the executive management structure of the NYSE.

Scandal affected the exchange in 2003 after revelations that Chairman Richard Grasso was awarded a $187.5 million pay package by a board of directors that he essentially controlled. One particularly irksome item was the $5 million bonus Grasso received for getting the exchange up and running after September 11, 2001. Thousands of others on Wall Street worked tirelessly at the time without any extra compensation.

Though Grasso is widely credited with preserving the New York exchange's share of the market for stocks, during his tenure the exchange developed a reputation for being an insiders' playground. His departure unleashed revelations

of possible trading abuses and conflicts of interest at the exchange and elsewhere in the financial industry, including a series of investigations by New York State Attorney General Elliot Spitzer. As of mid-2004, the functions of chairman and CEO have been separated, interim chairman John Reed proposed various reforms, and Attorney General Spitzer has sued Grasso for the return of his compensation package.

Discussion on the ending of the specialist system at the NYSE.

Currently, when an order comes in to the exchange, either by phone or electronically, it is sent to one of some 430 specialists, who handles all of the trading for that stock and several others. These specialists are the people in the colored jackets that can be seen in TV news shots of the trading floor. Each specialist, who is stationed at a booth on the floor of the exchange, essentially conducts an auction of his stocks, matching buyers and sellers or dipping into his own company's holdings to make sure there are enough shares available. Once buyers and sellers are matched, the specialist reports the results of the transaction and the information is sent out to quote systems so that others know the stock's most recent trading price. On electronic exchanges like NASDAQ, computers scan all the orders and match up buyers and sellers at the best available price.

Electronic order–matching for nearly all exchanges except the NYSE.

In contrast to the specialist system described above, when brokers receive an order to buy or sell a stock on an open-order environment (such as the NASDAQ in the U.S.), they have the option of directing that order to a market maker or to an electronic order–matching system. The electronic market provides the network to display bidding and asking prices. Electronic communications networks facilitate computerized matching of buy and sell orders.

Movement toward de facto globalization of the securities markets.

Although there is no single global marketplace for bonds and equities, there have been several initiatives to create a de facto world securities market. These include:

- Cross-listing of equity shares on home country and one or more foreign exchanges, allowing a company to expand its investor base and access to capital
- ADRs (American Depository Receipts), an investment security traded on a U.S. exchange as a receipt for shares originally issued and traded in another country
- Global registered shares, traded on multiple exchanges usually in U.S. dollars and euros
- Global bonds, a large international issue of debt sold simultaneously in the major bond markets in varying maturities and denominated in the major world currencies

See the Group of 30 website, www.group30.org, and its various publications, for example, Global Clearing and Settlement: A Plan of Action, 2003.

*****See Alfredo Mendiola and Maureen O'Hara, "Taking Stock in Stock Markets: The Changing Governance of Stock Exchanges," working paper, Johnson Graduate School of***

Management, Cornell University, 2003, for an analysis of the performance of the twelve publicly traded exchanges. Of the world's ten largest stock exchanges, only the NYSE and the Tokyo Stock Exchange are non-shareholder owned. Also, see "Searching for a New Center: US Securities Markets in Transition" at www.frbatlanta.org/news/CONFEREN/fm2004/OHara.doc.

Such developments admittedly have both positive and negative implications, but the effect inevitably will be to make the securities markets more efficient and less prone to sudden collapses, such as those that occurred in 1929 and 1987.

WHAT THE U.S. SHOULD DO

As we noted earlier in this chapter, financial markets require coordinated international control due to fiduciary responsibilities to depositors and to the risk of systemic collapse in the event of the failure of a major bank or securities firm. The essential point of these evolutionary adjustments is that global financial markets are "fixing" themselves, albeit with supervision. Differences in economic, social, and legal traditions complicate the process of reaching agreement on and enforcing procedures and standards. What may work in Mexico may not work in Russia or Japan, and political realities as well as economic pain cause delays, mistakes, and conflicting advice.

The realization that global financial markets are interdependent requires and generally achieves responsible behavior among governments and oversight agencies. The U.S. should continue to support and promote global efforts at oversight of financial markets.As to other business regulation, Walt Whitman's admonition that opens this chapter applies to the developed economies: the same ideas that apply to the U.S. apply internationally.

The interests of free trade and global competition have succeeded in restoring the world's economic systems in the post–World War II period, and to a degree far beyond anything previously experienced. The developed economies have various important future agendas, which we discuss in Chapter 10, but overseeing the regulation of business should not be on anyone's list.

ENDNOTES FOR CHAPTER 8

(Endnotes)

[1] There are several discussions of this "conflict" in the literature. See, e.g., Joel P. Tractman, "The International Economic Law Revolution," 17 University of Pennsylvania Journal of International Economic Law 33 (1996), discussing possible changes in international law to accommodate the weakening of national sovereignty; and Detlev F. Vagts, "The Governance of the Multinational," 23 Wisconsin International Law Journal 525 (2005), concluding, "It is still unclear what will transpire between nation-states and the multinational," at 539. Comments on the resulting "democracy deficit" – the lessening opportunity for democratic participation in international decision-making – have been made by Alfred C. Aman, Jr., "Globalization and Governance: The Prospects for Democracy," 10 Indiana Journal of Global Legal Studies 125, 148 (2003); and by Sol Picciotto, "Networks in International Economic Integration: Fragmented States and the Dilemmas of Neo-Liberalism," 17 Northwestern Journal of International Law & Business 1014, 1055-56 (1997).

[2] For a review of the development of jurisdictional principles, see David J. Gerber, "Beyond Balancing: International Law Restraints on the Reach of International Laws," 10 Yale Journal of International Law 185 (1984).

[3] For a discussion of the negotiations on the Treaty of Versailles that ended World War I, see Margaret Macmillan, Paris 1919 (2001). For a review of the Senate's debates and the ultimate rejection of the League of Nations, see Thomas J. Knock, To End All Wars: Woodrow Wilson and the Quest for a New World Order (reprint edition, 1995).

[4] UNESCO is the United Nations Educational, Scientific and Cultural Organization,

founded in 1945 to promote international cooperation among UN member states and associates in the fields of education, science, culture, and communication. SEATO was the Southeast Asia Treaty Organization, an alliance organized in 1954 by Australia, France, Great Britain, New Zealand, Pakistan, the Philippines, Thailand, and the U.S.. Following the defeat of the French in Indochina, SEATO was created to oppose further Communist gains in Southeast Asia. While it legitimized the U.S. presence in the Vietnam War, the U.S. abandoned the country in 1973 and the organization was disbanded in 1977.

[5] For an analysis of the role of the IMF in recent financial crises and the search for global financial stability and governance, see David Vines and Christopher L. Gilbert (eds.), The IMF and Its Critics: Reform of Global Financial Architecture (2004). The role of the IMF is undergoing an interesting reexamination as the global economy improves; see Matt Moffett and Bob Davis, "Booming Economy Leaves the IMF Groping for Mission," Wall Street Journal, April 21, 2006, A1, A12.

[6] The UN has made an impact on the international political climate in its ability to create new organizational mechanisms to deal effectively with the changing nature of conflict, which is steadily shifting from interstate wars to intrastate insurgencies. However, mistakes continue to be made, such as the scandal involving the Oil-for-Food program blamed by many observers on Secretary-General Kofi Annan. Other criticisms involve the organization's continuing problems in local dispute resolution, personnel assignment, financial mismanagement, and inadequate concerns for human rights. For a balanced recent assessment, see Thomas G. Weiss, David P. Forsythe, and Roger A. Coate, United Nations and Changing World Politics (2004).

[7] Protests in Seattle and other WTO meeting sites have alerted industrial countries to the developmental needs of poorer countries, particularly with regard to agricultural subsidies and special exemptions for certain industries and services. On

poor countries, see Keith Bradsher, "Vows of New Aid to the Poor Leave the Poor Unimpressed," New York Times, December 15, 2005, at select.nytimes.com/gst/abstract.html?res=F00E17FB34550C768DDDAB0994DD404482. On agricultural issues, see Keith Bradsher, "Trade Officials Agree to End Subsidies for Agricultural Exports, New York Times, December 19, 2005, at select.nytimes.com/gst/abstract.html?res=F40914FF3C540C7A8DDDAB0994DD404482. On exceptions, there are numerous reports of countries requesting special treatment, from India for textiles, to the pharmaceutical industry for generic drugs, to the European nations on American steel tariffs.

[8] See Alfred C. Aman, Jr., "The Globalizing State: A Future-Oriented Perspective on the Public/Private Distinction, Federalism and Democracy," 31 Vanderbilt Journal of Transnational Law 769, 791-816 (1998).

[9] A fiduciary is an organization that holds assets for another party, often with the legal authority and duty to make decisions regarding financial matters on behalf of the other party. Banks and securities firms are leading examples of fiduciaries.

[10] Based on an informal survey by the author, in the decade of the 1990s there were some 150 published analyses or commentaries on global financial crises. However, the flow of studies has slowed considerably in the past few years, probably due to the lack of a recent crisis.

[11] The efficient market hypothesis states that stocks trade at their fair value because existing prices incorporate and reflect all relevant information. Thus, it is impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices, and the only way an investor can possibly obtain higher returns is by purchasing riskier investments. This concept is incorporated in the Capital Asset Pricing Model (CAPM). See any standard text on corporate finance for a further explanation.

[12] Moral hazard is the potential loss when the provision of insurance or guaranties encourages the affected parties to take more risks.
[13] Germany's Herstatt Bank is a famous example of a banking failure due to settlement risk. On June 26, 1974, Herstatt had taken in all its currency receipts in Europe but had not made any of its U.S. dollar payments when German banking regulators closed the bank down at the end of the German business day. Counterparties were left holding unsecured claims against the bank's assets.

[14] See Overview of the New Basel Capital Accord, April 2003, at www.bis.org/bcbs/cp3ov.pdf. For a brief history of Basel I and II from a U.S. perspective, see www.federalreserve.gov/boarddocs/press/bcreg/2005/20051006/default.htm.

[15] Arbitrage is the simultaneous buying and selling of an asset, usually in different markets where price differences may exist due to imperfect information, speculation, or other factors.

[16] Damian Paletta, "U.S. Banking Regulators Agree on Basel II Capital Standards," Wall Street Journal, July 21, 2007, A4.

[17] For all banks, the decline is about 13.75 percent. Federal Reserve Bulletin, Table A.2.A/B, Spring 2004, at www.federalreserve.gov/pubs/bulletin/2004/04springbulletin.htm.

[18] See "Profits and Balance Sheet Developments at U.S. Commercial Banks in 2003," Federal Reserve Bulletin, Spring 2004, at www.federalreserve.gov/pubs/bulletin/2004/spring04_profit.pdf.

[19] Financial securitization gathers similar assets together to create securities that can be sold in public markets. Banks use this technique to remove a particular group of

assets – such as mortgages – from their balance sheets, transferring them to investors willing to accept the risk that there may be default on some of the loans or a general rise in interest rates. In return for accepting these risks, investors receive the revenue stream generated by the assets, e.g., the mortgage interest paid by homeowners.

[20] For example, see the French proposal to vest additional decision-making power in the Interim Committee of finance ministers that oversees the operation of the IMF, with the goal of enhancing accountability, allowing the institution to respond more quickly to crises; or the Canadian proposal providing for an IMF-sanctioned pause or payments standstill to be invoked in the event of financial difficulties. Government of France, Facing International Instability: Twelve Proposals for a European Initiative (1998). Canada, Department of Finance, "Finance Minister Announces Six-Point Canadian Plan to Deal with Global Financial Turmoil," Press Release, 1998; at www.fin.gc.ca/news98/98-094.e.html.

[21] The balance of payments is a report of all transactions by a country with other nations, including imports, exports, aid, and military expenditures. The two components of a country's balance of payments are the current account, the net of exports and imports of goods and services; and the capital account, the net change in assets and liabilities. Typically a country with a large current account deficit will experience equivalent purchases of assets, including financial assets (e.g., stocks and bonds) and physical assets (e.g., companies and real estate).

[22] In 2006, exports were $2.096 trillion, and imports were $2.818 trillion, a current account deficit of $722 billion. See "Table A: Summary of U.S. International Transactions" (July 2007), at www.bea.gov/scb/pdf/2007/07%20July/0707_itaq_text.pdf.

[23] Like every generalization one can make about economic behavior, there will

always be important exceptions to this observation. A current example is Venezuela, whose leader, President Hugo Chávez, seems intent on nationalizing important industries and driving away investors with capital.

[24] See, e.g., Jane Little, "Regional Review: The IMF Under Fire," Federal Reserve Bank of Boston (Quarter 2, 1998), at www.bos.frb.org/economic/nerr/rr1998/q2/litt98_2.htm; or U.S. Congress, Joint Economic Committee Study, "IMF Financing: A Review of the Issues" (March 1998), at www.house.gov/jec/imf/imf.htm.

[25] Bank for International Settlements, Sovereign Credit Default Swaps, BIS Quarterly Review, December 2003, at www.bis.org/publ/qtrpdf/r_qt0312g.pdf.

[26] Extrapolated from Office of the Comptroller of the Currency statistics; see www.occ.treas.gov/ftp/deriv/dq303.pdf.

[27] "Financial Derivatives," Remarks before the Futures Industry Association, Boca Raton, Florida, March 19, 1999; reprinted at www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm.

CHAPTER 9:
ECONOMIC ANALYSIS OF BUSINESS REGULATION

The age of chivalry has gone.
That of sophisters, economists, and calculators has succeeded,
and the glory of Europe is extinguished forever.
Edmund Burke (1729–1797), Reflections on the Revolution in France

This chapter should discuss details of the economics of business regulation, that is, the use of quantitative analysis to determine the contribution that legislation and administrative decision-making have made to the improvement of American competitiveness and productivity. However, it is somewhat astonishing to report that a few pages would suffice to review the various studies conducted on the relevant costs and benefits as analyzed by Congress, the President, and the various regulators noted throughout this book. Instead, we will consider what should be done, in reasonably practicable terms, to provide such analysis.

STANDARD ECONOMIC METHODOLOGY

Congress has passed numerous laws to regulate business, several of which were discussed in Part I. The U.S. has been emulated by various countries and international organizations in the effort to control the activities of companies, and some of these efforts have been described in Part II. Rather than economic analysis, laws were passed on a good faith basis, in the general belief that there was evidence of fraud, collusion, or other wrongdoing and that the public needed to be protected.

APPROPRIATE ECONOMIC ANALYSIS

In reviewing these actions in the U.S. and in other countries, it is difficult to find a single instance where economic analysis was performed to determine the appropriateness of a business regulation.[1] This comment applies to all phases of the process: the consideration of the law establishing the regulation; the regulatory process as proposed by the administrative agency ("ex ante analysis"); or the period following some experience with the regulation ("ex post analysis").

The applicable economics should specify four types of benefits and costs.

1. Benefits that develop through greater competition, improved corporate governance and public trust, and general confidence in the stability and safety of markets.

2. Direct costs to the government, which arise as an administrative entity enforces controls and courts hear cases brought by the government or private plaintiffs against supposed "violators."

3. Direct costs to business, including the additional expenses of compliance, the pursuit of suboptimal strategies due to legal barriers, and the costs of litigation or advocacy at administrative hearings. Where they were known or could be reasonably estimated, we listed the direct costs to business in Part I.

4. Implicit costs that occur as the result of regulation but are difficult or impossible to quantify. We will discuss these costs later in this chapter.

THE THEORY OF COST-BENEFIT ANALYSIS

When governments attempt to use economic analysis, the standard is generally cost-benefit analysis (CBA). The future stream of anticipated benefits is quantified and discounted to their present value using a specified interest or discount rate, and this total is compared to the costs incurred in generating the benefits in a ratio format. As a simple example, a public project that yields $500,000 million in benefits for ten years and costs $1 million to implement would yield a cost-benefit ratio of about four and a quarter times assuming a 3 percent discount rate.[2]

The naïve government official might claim that the cost-benefit ratio is five times, as $500,000 for ten years divided by $1 million appears to produce an arithmetic result of five. However, the CBA must reduce benefits received in the future at a predetermined discount rate. The general rule is that projects with a CBA that exceed one should be undertaken, and in situations of capital limitations – which all governments experience – the projects with the highest ratios should be given priority, assuming that other considerations, such as public safety or national security, do not take precedence.

This approach provides the cover of preciseness and is seemingly objective, although astute observers will note that judgment calls and guesses are required to conduct the analysis. It is particularly difficult to evaluate projects with a large number of possible outcomes with many interests of stakeholders affected by the decision. Representatives of various constituencies may lobby for their viewpoints, and decisions may be based on the demands of the moment rather than on a coherent long-term policy. For example, the SEC was rushed into existence by the Roosevelt Administration because of the bad acts of a few Wall Street investment bankers, while the Sarbanes-Oxley Act essentially resulted from the collapse of Enron and the problems at WorldCom, Tyco, and other companies.

ASSUMPTIONS IN CBA

CBA is a capital budgeting technique closely resembling the two major business capital budgeting methods, net present value (NPV) and internal rate of return (IRR). The major requirements of NPV, IRR, and CBA are that:

- The project life is knowable. However, how can one accurately determine the life of a dam, a bridge, a manufacturing facility, or restrictions on aggressive competitive behavior of a business?
- The magnitude and timing of the cash inflows (benefits in CBA) and cash outflows (costs) can be specified. Every manager can cite projects with cost overruns or unexpected delays and glowing opportunities that turned into major disappointments or disasters.

A third problem exists with CBA that is not present in the private sector: the determination of the correct discount rate. We calculate the weighted average cost of capital (WACC or ACC) based on the proportion of debt and equity used to finance a business times the after-tax cost of each; see any standard corporate finance text for an explanation of these concepts. Businesses experience a wide range of WACCs, depending on such factors as the market's perception of risk, the size of the company relative to its industry, the maturity and innovation of the business, and numerous other factors. For WACCs of typical U.S. companies, see Figure 9-1.

Figure 9-1:
Costs of Capital for Selected Companies

Company	Cost of Debt Capital (%)[1]	Cost of Equity Capital[2]	Percentage of Debt on Balance Sheet[3]	Percentage of Equity on Balance Sheet[4]	Weighted Average Cost of Capital (%)[5]
Boeing	5.1	8.3	21	79	7.2
Dell Computer	8.1	14.5	1	99	14.4
ExxonMobil	4.7	5.9	2	98	5.9
General Electric	4.7	9.8	21	79	7.6
H. J. Heinz	5.0	5.1	26	74	4.6
McDonald's	4.9	9.3	18	82	8.2
Pfizer	4.7	6.2	4	96	6.1
Wal-Mart	4.8	6.6	9	91	6.3

[1] Note: All calculations are based on data from late 2005.
The cost of debt capital is calculated from average yields on similarly rated bonds.

[2] The cost of equity capital is based on Capital Asset Pricing Model estimates.

[3] The proportion of debt is based on each company's book value of debt plus any preferred stock issued.

[4] The proportion of equity is based on the market value of each company's common stock.

[5] *The weighted average cost of capital is based on the percentage of debt times the after-tax cost of debt capital (using an assumed 35 percent tax rate), plus the percentage of equity times the cost of equity capital.*
Source: Richard A. Brealey, Stewart C. Myers, and Alan J. Marcus, Fundamentals of Corporate Finance (5th edition, 2007), Table 12-4, 334.

DISCOUNT RATES AND BENEFITS

The analysis is not as simple as our previous example when realistic discount rates and a full benefits listing are provided. We'll briefly discuss each of these issues.

PUBLIC AND PRIVATE DISCOUNT RATES

Government has no equivalent for the cost of capital, so the Office of Management and Budget (OMB) assigns the appropriate rate to use, based primarily on the U.S. government's borrowing costs. An annual OMB circular[3] lists interest rates for various types of government-mandated CBA analyses; see Figure 9-2 for the 2006 rates. While this approach at least brings consistency to the analysis of public projects, it cannot be argued either that:

- Any one discount rate reflects the true cost of actions forgone or actions protected by law for businesses of all sizes and risks

  or that:

- The OMB's rate of 3 percent (30-year real interest) is representative of the cost of capital experienced by American business in coping with business regulations.

FIGURE 9-2:
FEDERAL GOVERNMENT DISCOUNT RATES FOR COST BENEFIT ANALYSIS

Estimated Project Life	Nominal Interest Rates	Real Interest Rates
3 year	4.7%	2.5%
5 year	4.8%	2.6%
7 year	4.9%	2.7%
10 year	5.0%	2.8%
20 year	5.3%	3.0%
30 year	5.2%	3.0%

Note: Nominal rates are stated rates as used in the Budget of the U.S. Government for fiscal year 2006. Nominal rates are used in lease-purchase decisions. Real rates are determined based on nominal rate forecasts but after the removal of the inflation premium. Real rates are used in cost benefit analysis.

Source: OMB Circular No. A-94, "Discount Rates for Cost-Effectiveness, Lease Purchase, and Related Analyses," Appendix C, revised January 2006; at www.whitehouse.gov/omb/circulars/a094/a94_appx-c.html.

A more realistic rate for private (business or industry) benefits would probably be determined using the WACC concept. The following explanation uses rates as of mid-2006. We can use the after-tax rate on "AA" rated long-term debt for the cost of debt capital, equal to 3.75 percent.[4] The cost of equity capital is based the Capital Asset Pricing Model (CAPM), which defines the market rate as:

$$R_e = R_f + \beta\ (R_m)$$

Where: R_e is the cost of equity capital

R_f is the risk-free rate on short-term U.S. Treasury bills, about 5 percent

β is the Beta for a portfolio of stocks (defined as 1.0 based on the Standard & Poor's 500 market index)

R_m is the market risk premium calculated over the past eight decades of stock market experience, about 7.0 percent5

The result is that R_e equals R_f (5 percent) plus a Beta of 1.0 times the current market risk premium of 7.0 percent, for a total of 12 percent.

The WACC for private benefits is about 9.5 percent, assuming that 30 percent of the typical balance sheet is funded by debt and 70 percent by equity; see Figure 9-3. Compare this to the WACC equivalent for public benefits of 3 percent as specified by the OMB; it's less than one-third of the rate for private benefits! If the capital markets are about right for the private sector, it is hard to reconcile the corporate cost of capital with the OMB public sector amount.

Figure 9-3:
Calculation of Average Cost of Capital

	Assumed Proportion of Balance Sheet	Cost of Each Form of Financing*	Weighted Cost of Financing
Debt	30%	0.0375	0.01125
Equity	70%	0.1200	0.08400
Total	100%		0.09525

***See explanation in text.**

POSSIBLE BENEFITS RESULTING FROM BUSINESS REGULATION

Benefits are either public or private depending on specific situations. A public benefit accrues to everyone; a private benefit applies to specific constituencies. For example:

- Antitrust advocates would probably argue that private benefits include elimination of conditions of restraint of trade or monopoly within an industry and that public benefits involve the avoidance of injury to competition and to the consumer.
- Bank tying opponents might stress the private benefit of unbundling credit and noncredit services offered to corporate clients and the resulting access to credit for borrowers. Public benefits could include greater access to banking services for businesses and consumers.
- Proponents of corporate governance would certainly discuss the prevention of fraud and the resulting public benefit to society and the private benefit to shareholders in avoiding reduced stock prices and adverse publicity.
- Airline passengers would be enthusiastic about the public benefit of fewer flight delays and having more choices among carriers at their local airport. Private benefits enjoyed by the airlines may include more gate access and improved aircraft utilization.

If the government were to calculate benefits, it would clearly overestimate the result when true WACCs are applied to private benefits. Our earlier example of $500,000 in benefits for ten years and costs of $1 million yielded a cost-benefit ratio of about 4.25 times with a 3 percent discount rate. Assume now that benefits were split equally among public and private constituencies. The resulting CBA would fall to about 3.7[5] times, still worth the investment but certainly not overwhelmingly so.[6] And if public funds have to be rationed among alternative projects, this investment may very well fail to be accepted. Furthermore, for a large number of projects, the CBA might fall further when the benefits are valued against realistic costs.

WHAT DOES THE GOVERNMENT COMPILE?

The leading source of federal CBA studies is the annual report of the Office of Management and Budget (OMB) that shows the total annual benefits and costs of major rules.[7] For the 2005 report, OMB listed costs and benefits from eight federal departments and one agency, including Agriculture, Education, Energy, Health and Human Services, Homeland Security (the Coast Guard only), Housing and Urban Development, Labor, Transportation, and the Environmental Protection Agency.

The 2005 CBA results are impressive, with benefits ranging from $68 to $260 billion and costs between $34 and $39 billion, far exceeding the required CBA standard of one or greater (as previously explained). The OMB and the legislation and regulations that support CBA do not differentiate between public and private benefits and calculate all benefits based on the OMB public discount rate. It should also be mentioned that OMB uses the reports of the agencies rather than its own calculations, a procedure that has engendered considerable controversy.[8]

Readers will note that the administrative organizations responsible for the business regulation discussed in this book – the SEC, the Justice and Commerce Departments, the Office of the Comptroller of the Currency, and the FAA – are not even mentioned in the OMB report. While this omission is never explained, the reason is quite obvious: no CBA or other economic analysis

has ever been required to justify the existence of these laws and regulations! Congress simply assumed that the costs and benefits were appropriate to each situation, and never systematically considered the need for an economic review at the time of the passage of the legislation or in the years following implementation.

OTHER CBA ANALYSES

There is limited academic research on the costs (but not the benefits) of regulation available through the Mercatus and Weidenbaum Centers.[9] The reported data are based on social and economic oversight, with the latter category most closely matching the topic of business regulation.[10] The estimated cost of economic regulation will be $5.8 billion in fiscal year 2006, up from $1.2 billion in 1980 and $2.5 billion in 1990, about a 5 percent annualized growth rate (in the 1990 to 2006 period). Specific agency or department costs for the business regulation portion are presented in Figure 9-4, and total about $3.25 billion.

Figure 9-4:
Costs of Business Regulation
(selected federal regulators)

Department or Agency	Spending (millions of current dollars)	Staffing (full-time equivalent)
Department of the Treasury		
• Comptroller of the Currency	$ 522	2,811
• Office of Thrift Supervision	193	920

Department or Agency	Spending (millions of current dollars)	Staffing (full-time equivalent)
Federal Deposit Insurance Corporation	634	3,244
Department of Commerce		
• Bureau of Industry and Security	83	431
• International Trade Administration	65	408
• National Telecommunications and Information Administration	57	298
Federal Communications Commission	389	1,987
Department of Justice		
• Antitrust Division	141	851
Federal Trade Commission	210	1,080
International Trade Commission	65	375
Securities and Exchange Commission	886	3,933
TOTAL	$ 3,245	16,338

Note: Various organizations have been excluded from this table; examples include the Comptroller of the Currency, the Farm Credit Administration, the Federal Reserve System, the Agriculture Marketing Service (within the Department of Agriculture, and various others that do not directly impact business regulation as considered in this book.

Source: Susan Dudley and Melinda Warren, 2006 Regulators' Budget Report, a joint publication of the Mercatus Center (George Mason University) and the Weidenbaum Center (Washington University); at www.Mercatus.org and wc.wustl.edu.

The list includes the cost of important business regulators, but it does not delve into the specifics of necessary activities as opposed to those that restrict the freedom of action by business. For example, we do not know the breakdown of the SEC budget and how much is spent on Sarbanes-Oxley implementation versus such other activities as the review of proposed offerings of securities by corporations. In the absence of a systematic review of the actual costs of such regulation, it is probable that the final amount would be $1.5 to $2 billion a year. It certainly can be argued that this sum would easily be worth the efforts of possibly 10,000 in staff working to regulate business or that this amount is dwarfed by the size of the total federal budget (about $2.6 trillion in 2006[11]). However, the benefits are unknown, and the costs discussed so far do not address the implicit costs that inevitably exist and should be included in any objective analysis.

IMPLICIT COSTS OF GENERAL BUSINESS REGULATION

Implicit costs result from restrictions on a company's freedom to operate, to innovate and to survive, and to grow or fail. The extent of implicit costs in any grouping of business regulation is a function of the extent of previous deregulation. For example, corporate governance has eight general categories of implicit costs, while the airline industry, which has been deregulated, contains only two categories. This section includes the general business regulation of antitrust and corporate governance.

IMPLICIT COSTS OF ANTITRUST

The implicit costs of antitrust include the following:

1. Predictability in Law Enforcement. As reported in Business Week, the Rehnquist Supreme Court disinterest in antitrust left business and legal counsel uncertain as to how to proceed in managing companies.[12] The current Roberts Court has adopted a friendly attitude toward business, but decisions in 2006–2007 were based on fairly narrow issues and could change as justices retire or die and a new President considers options for appointments.[13]

Predictability is an essential component in operating any business,[14] particularly in the current economic climate which has forced companies to look for innovative ways to increase revenues and decrease costs. Possible strategic initiatives include outsourcing, downsizing, internal growth, and merging with competitors. Yet mergers may be rejected by the government despite the economic logic and significant opportunities for efficiencies. One case in point was the proposed and quite reasonable merger of the office supplies retailers Staples and Office Depot, which was rejected as a potential restraint of trade.[15]

2. Consistency in Judicial Review. Most cases go to trial and, based on the facts and the law, counsel says "you'll win" or "you may lose – let's settle." With antitrust, there simply is no consistent body of common law precedents that clearly indicate how courts will decide. Microsoft clearly lost in Judge Jackson's court. On appeal, the case was remanded. On retrial, Microsoft effectively won. Judges do not know how to rule given the uncertainty of defining a market, the standards of review that should be applied, or which economic theory to apply.

3. Protection of Inefficient Producers. The innovative, aggressive company had best assume that the law or its competitors will be breathing down its neck. If competitors fight in the public marketplace, that is the essence of capitalism. But if inefficient competitors run to regulators, lobbyists, or legislators for protection, the concept becomes subverted.[16] And the prospect of treble damages, as permitted in the Sherman Act,[17] may be sufficient incentive to entrap the unsuspecting business competitor.[18] The mere threat of litigation makes many companies pay up and settle, or cave in to demands to drop a merger or other acquisition strategy.

4. Confusion over Corrective Actions. With the exception of attorneys and regulators who make their living from antitrust, it is difficult to find any thoughtful commentator who supports antitrust in its present form. A few of the solutions and remedies that have been suggested include:

- More government: develop new law on competition including additional institutional mechanisms for review.[19]
- Global antitrust: create a global antitrust policy through the World Trade Organization or other international agency.[20]
- Special rules: extend exemptions to antitrust to avoid a "tragedy of the commons"[21] with regard to the environment, energy, and possibly other situations in the national interest.
- Hold hearings: begin oversight review to determine twenty-first-century requirements for antitrust.[22]

There are literally hundreds of books and articles on antitrust available to the interested reader, each with its own set of solutions. Imagine the scramble for new law review and economic journal topics if Congress were ever to take decisive action!

IMPLICIT COSTS OF THE REGULATION OF CORPORATE GOVERNANCE

The implicit costs of regulating corporate governance include the following:

1. Agency costs. A corporation requires management by nonowner agents due to the number and dispersion of owners (stockholders). Fraud cases like Tyco turn on managers who use their control to benefit themselves rather than the owners. In response to increased regulation, it is likely that managers will seek to insure against potential liability or behave cautiously because of the risk of harming their reputations. The resulting shifting and expense of risk will be an extra cost to the firm and its stockholders.

2. Resource allocation. Increased liability and regulation may affect the flow of resources to particular businesses. Firms whose earnings are variable, that are in lines of business where the accounting standards are somewhat uncertain, or that use now-suspect business practices such as hedging and derivatives are all subject to increased risk. Other things being equal, increased liability and regulation will reduce the value of "suspect" firms as well as their ability to attract financial and human capital.

3. Information costs. Post-fraud case regulation impacts information costs by increasing internal data-gathering requirements and auditing and consulting fees. A significant problem is that some provisions of Sarbox are vague, requiring companies and auditors to interpret and possibly

exceed the requirements that would fulfill the statute.[23] Although firms may develop more and higher-quality information, it is problematical whether the increased benefits outweigh the costs.

4. Investor risk estimates. Investors and the public generally overestimate risks and the need for regulation, leading to lower stock prices and a higher weighted average cost of capital. These effects are exacerbated by the media's incentive to sell the story of corporate fraud as a continuing saga of wrongdoing that readers or viewers follow every day rather than as discrete events.

5. Effective denial of access to public markets. Large, established corporations will find it easier to comply with new regulations than smaller or newer firms, thereby perversely gaining from corporate frauds. Smaller companies may decide to become private or to avoid the U.S. public markets to avoid the costs of regulatory compliance.[24] Meredith Enterprises and Vermont Teddy Bear, two typical situations, made decisions to privatize in 2005, citing the requirements of Section 404.[25] The SEC is considering exempting smaller companies from certain of these rules, although no decision has yet been announced.[26] The whole idea of using the public markets to assist small companies in raising capital is subverted by Sarbox.[27]

6. Costs of management refocus or separation. The traditional role of management has been to analyze and develop responsive business strategies. Management time is used suboptimally to the extent of its refocus on regulatory compliance rather than on business decision-making.[28] Some financial managers have departed or are considering leaving their positions because of Sarbox pressures. An example is the comptroller of Urban Outfitters, whose days are spent "documenting

countless procedures and processes” while his job turns into “a struggle to explain common sense.”[29]

7. Compromise of internal auditing. Internal auditors serve the important and often unsung function of providing review and control of customary corporate accounting activity. Without internal auditors, effective procedures would be lacking to ascertain the accuracy of journal entries, the proper management of cash, the safeguarding of assets, and the payment of liabilities based on appropriate reviews. Since the passage of Sarbox, up to half of internal auditing staff time has been assigned to the development of internal controls and other compliance issues.[30] The result has been the compromise of the integrity of the financial statements of public companies.

8. New litigation. Legal analysis clearly supports the right of Congress to pass Sarbox and to assign administrative responsibilities to the SEC.[31] However, two possible challenges to the law have been identified:

- Executive branch appointments are governed by the Constitution, with the responsibility assigned to the President and confirmed by the Senate.[32] Under Sarbox, the SEC appoints the members of the PCAOB without any review by appropriate authority. A suit testing the constitutionality of Sarbox on these grounds was filed in early February 2006 by the Free Enterprise Fund.[33]
- A weaker challenge could be pursued under the Administrative Procedure Act of 1946 (APA)[34] and the SEC’s Rules of Practice[35] which together formalize the deliberative process by which SEC rules are made. Perhaps most significantly, the APA requires notice of proposed legislative rulemaking and the opportunity for the public to comment on the proposed rule. The SEC has refused to respond

to reasonable and thoughtful ideas on potential reforms, estimated at over 2,000 suggestions, opening this possibility for future litigation.

IMPLICIT COSTS OF INDUSTRY-SPECIFIC BUSINESS REGULATION

The industries reviewed in Part I were banking, financial services, and the airlines. Although significant deregulation has occurred in these sectors, continuing implicit costs are noted in the sections that follow.

IMPLICIT COSTS OF BANKING AND FINANCIAL SERVICES REGULATION

The implicit costs of banking and financial services regulation include the following:

1. Low profitability. For seven decades, banks were restricted to doing business in the state in which they were chartered (with certain limited exceptions). Although the Riegle-Neal Act now permits full interstate banking, there are still about 7,500 banks in the U.S. We previously noted the low profitability of the banking sector and the resulting struggle to find attractive uses for the capital raised through retained earnings (profits) and debt. Banks must be able to show returns commensurate with those of other users of invested funds, particularly as technology and globalization places U.S. banks in direct competition with international, regional, and community financial institutions. Eliminating tying restrictions would permit banks to increase their focus on profitable corporate relationships, allowing them an opportunity make a fair return on capital.

2. Inefficiency in corporate services. The prohibition on the payment of interest on corporate demand deposit (checking) accounts forced the creation of the sweep family of products, a rather inefficient process to generate earnings on bank balances. In the absence of sweeps, balances would either sit idle or earn nominal earnings credits to use against charges for bank services. The Federal Reserve has opposed proposals to end this restriction, claiming that the U.S. Treasury would lose an annual \$100 million.[36] However, that money belongs to corporate depositors and not to the government and effectively constitutes a tax on American business. It should also be noted that small and medium-sized companies pay a disproportionate share of this cost, as they often cannot use the sweep option because the monthly fees for the product can be in excess of \$100 or because their community bank does not offer the service.

3. Inappropriate regulatory coverage. The passage of the Gramm-Leach-Bliley Act of 1999 allowed financial services companies to enter any financial business but did not change the regulatory mix that provided oversight and protection for depositors, policyholders, shareholders, and the general public. Mismanagement does occur, and in cases of failures like Executive Life, Mutual Benefit Life, Franklin National Bank, Allfirst Bank (of Maryland), and Drexel Burnham Lambert, everyone loses, including taxpayers, employees, and the community. The regulatory structure should be consolidated to reflect the types of integrated strategies pursued by large financial companies. A logical organization would be to focus on institutional and individual concerns as discussed at the end of Chapter 4. A lesson of history is that inappropriate regulation inevitably leads to a corporate collapse somewhere and sometime, and such a failure will quickly turn into a very costly affair.

IMPLICIT COSTS OF AIRLINE REGULATION

The implicit costs of airline regulation include the following:

1. Restrictions on mergers. The U.S. airline industry clearly has too many participants. Founder-owner egos, bad decision-making, and easy entry have created marginal carriers that have only a slight likelihood of earning a reasonable return in the long run. Ticket prices are often irrational, may be substantially less than the equivalent cost if the journey were made by automobile,[37] and are developed primarily to fill seats. It can be argued that private capital has the right to be irrational; however, airlines use public facilities including the FAA, airspace, and airport facilities. The public, the passenger, and the investor or lender all have a stake in rationalizing the industry. The logical solution is consolidation through merger.

2. Limitations on carrier access to public facilities. As noted above, airlines use various types of public facilities. As long as a fair price is paid for access to those facilities, all carriers should be treated equally by airports and the FAA. Furthermore, efficient solutions to managing airspace should be sought, whether it involves technology, peak-hour pricing, privatization, or other innovations.

WHAT THE U.S. SHOULD DO

While it appears that our focus on public and private benefits, and on explicit and implicit costs, is unique, there have been any number of studies criticizing CBA, the regulatory process, and other components of business regulation.[38] The general thrust of these reports is that the methodology is seriously flawed, with such absurd findings as the saving of a life costing as much as $72 billion![39] Some commentators would improve the process;[40] our recommendations have been noted throughout this chapter.

The existence of so many categories of implicit costs of business regulation should have caused some in Congress to consider applying the same cost-benefit analysis required in social regulation. We could fairly easily quantify several of these costs, such as the cost of litigation (the cost of trials and appeals) or denial of access to public markets (the incremental cost of capital for financings) for corporate governance, or lowered profitability because of restrictions on tying arrangements (the difference between actual and market average returns) for banks. Other costs are obviously more difficult to quantify, such as consistency in judicial review for antitrust or inappropriate regulatory coverage for financial services companies.

In any event, the total of the costs for business regulation could very well exceed the present value of any benefits generated. This is particularly likely when the true discount rate – the business cost of capital and more than three times the OMB rate – is used in calculating the present value of private benefits. While admittedly difficult, this analysis has never occurred, and regulations continue regardless of economic justification. Despite these significant problems in the application of CBA to public choice, all branches of government are dependent on the results attained from some form of economic analysis. Rather than try to push the proverbial camel through the eye of a needle,[41] the solution may be to quantify those benefits and costs that can be quantified and to overtly recognize and discuss those that cannot. This is clearly preferable to ignoring these factors and blindly assuming that antitrust or corporate governance or any other area of business regulation is worth any price paid.[42]

ENDNOTES FOR CHAPTER 9

(Endnotes)

[1] The leading book on international business regulation does not have a single entry for economic analysis or any related topic. See John Braithwaite and Peter Drahos, Global Business Regulation (2000).

[2] The calculation is $500,000 times the interest factor 8.530 (the present value of an annuity for ten years at 3 percent), equal to $4,265,000, ÷ $1,000,000, or 4.265 times. It will become clearer in the next section why the 3 percent rate was chosen.

[3] OMB Circular No. A-94, “Discount Rates for Cost-Effectiveness, Lease Purchase, and Related Analyses,” Appendix C, revised January 2006; at www.whitehouse.gov/omb/circulars/a094/a94_appx-c.html.

[4] Calculated as 5.75 percent times (1 – U.S. corporate tax rate of 35 percent) = 3.75 percent.

[5] Based on calculations in Richard A. Brealey, Stewart C. Myers, and Alan J. Marcus, Fundamentals of Corporate Finance (2007), from data in Elroy Dimson, Paul Marsh, and Mike Staunton, Triumph of the Optimists: 101 Years of Global Equity Returns (2002) as updated by the authors.

[6] The calculation would be similar to note 2, but using 6.281 as the interest factor for the private benefits portion would result in a CBA of 3.70.

[7] The data cited are from the 2005 Report to Congress on the Costs and Benefits of Federal Regulations, Office of Management and Budget, Table 1-2, 8. For the most recent data, see www.ombwatch.org/regs/regacctg/2006/2006Draft.pdf.

[8] See, for example, Robert W. Hahn and Rohit Malik, "Is Regulation Good for You?" 27 Harvard Journal of Law & Public Policy 893 (2004), disputing the OMB's methodology; and James L. Gattuso
(The Heritage Foundation), "Comments to the Office of Information and Regulatory Affairs, OMB," on the 2004 Draft Report to Congress on the Costs and Benefits of Federal Regulations, at www.whitehouse.gov/OMB/inforeg/2004_cb/5.pdf.

[9] The Mercatus and Weidenbaum Centers are at George Mason University and Washington University, respectively; see www.Mercatus.org and wc.wustl.edu. These analyses are in the annual Regulators' Budget Report; the data that follow are from the 2006 report, authored by Susan Dudley and Melinda Warren.

[10] Social regulation reports activities for consumer safety and health, homeland security, transportation, the workplace, the environment, and energy. The only social category discussed in this book is transportation, which includes the FAA (see Chapter 5) and the various other transportation modes largely under the jurisdiction of the Department of Transportation. Because it is impossible to separate FAA functions into business and safety costs, that agency is excluded from the comments which follow in this chapter.

[11] Budget of the U.S. Government, Fiscal Year 2006, Table S-1, 343.

[12] See "The Hands-Off Rehnquist Court," Business Week, July 25, 2005, 34.

[13] See "The Supreme Court: Open for Business," Business Week, July 9, 2007, at www.businessweek.com/magazine/content/07_28/b4042040.htm?chan=search.

[14] This point is made by Fred L. Smith, "The Case for Reforming the Antitrust Regulations (If Repeal Is Not an Option)," 23 Harvard Journal of Law & Public

Policy 23, 42 (1999).

[15] FTC v. Staples, Inc., 970 F.Supp. 1066 (1997). The proposed merger was analyzed and then opposed by the Federal Trade Commission ("FTC"). For a news report of the decision, see "A 3-Way Shootout in the Paper-Clip Corral," New York Times, September 7, 1997, §3, 8. For a law review analysis, see Armando E. Rodriguez and Malcolm B. Coate, "Merger Pitfalls In Practice: Three Case Studies," 20 University of Pennsylvania Journal of International Economics and Law 793, 816-22 (1999).

[16] See Robert H. Bork, The Antitrust Paradox (1978), at 41-47.

[17] At 15 U.S.C. § 15(a).

[18] See Kenneth G. Elzinga and William Breit, The Antitrust Penalties: A Study in Law and Economics 84-90 (1976), citing Russellville Canning Co. v. American Can Co., 87 F.Supp. 484 (1949).

[19] Reza Dibadj, "Saving Antitrust," 75 University of Colorado Law Review 745 (2004).

[20] Eleanor M. Fox, "Global Markets, National Law, and the Regulation of Business," 75 St. John's Law Review 383 (2001).

[21] From Garrett Hardin, "The Tragedy of the Commons," 162 Science 1243 (1968). See the analysis in Bruce Yandle, "Antitrust and the Commons: Cooperation or Collusion?" 3 The Independent Review 37 (1998); at www.independent.org/pdf/tir/tir_03_1_yandle.pdf.

[22] See Smith, reference in note 14, at 55.

[23] See Terry Kosdrosky, “Meetings, Time and Money,” Crain’s Detroit Business, November 14, 2005, 11.

[24] See, for example, Mark Landler, “Germans Weigh Taking Stocks Off Wall Street,” New York Times, November 20, 2004, C1-C2; at www.nytimes.com/2004/11/20/business/worldbusiness/20listing.html? adxnnl=1&oref. Foley & Lardner found that 20 percent of respondents were considering going private in a 2004 study. See Deborah Solomon, “Corporate Governance – At What Price?” Wall Street Journal, October 17, 2005, at www.issproxy.com/pressroom/inthenews/101705wsj.htm.

[25] Meredith Enterprises cited costs associated with § 404; Solomon, ibid. Vermont Teddy Bear’s CEO Elisabeth B. Robert stated: “As a private company, Vermont Teddy Bear will no longer face the challenges of a small company trying to comply with increasingly complex and costly public company requirements.” See also Diya Gullapalli, “Living with Sarbanes-Oxley,” Wall Street Journal, October 17, 2005, R1; at online.wsj.com/article_print/SB112922100637567825.html.

[26] John Labate, “Here’s a Loophole that the Feds Would Create on Purpose,” Treasury & Risk Management, February 2006, 28.

[27] The SEC is providing some slight relief to companies with less than $75 million in market capitalization by delaying internal control requirements (under § 404) until mid-2007.

[28] According to a leading executive search firm, Spencer Stuart, the pressures of Sarbox have led to the departures of 225 CFOs of Fortune 500 companies in the last three years. See Claudia H. Deutsch, “Where Have All the Chief Financial Officers Gone?” New York Times, November 28, 2004, BU 5.

[29] See Tim Reason, “Feeling the Pain: Are the Benefits of Sarbanes-Oxley Worth the Cost?” CFO Magazine, May 2005, 50-51.

[30] See Eric Krell, “Is Sarbanes-Oxley Compromising Internal Audit?” 11 Business Finance 19 (2005).

[31] Joan M. Heminway, “Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance,” 10 Fordham Journal of Corporate and Finance Law 225, 248-62 (2005).

[32] Article II, Section 2 of the Constitution also provides for lower-level officials, who must be selected by the President, the courts, or a cabinet department head. The SEC is not a cabinet-level department.

[33] See Kara Scannel, “Suits Seek to Overturn Sarbanes-Oxley Law,” Wall Street Journal, February 8, 2006, C6; and Amy Borrus, “Who Watches Accounting’s Watchdog?” Business Week, February 8, 2006; at www.businessweek.com/investor/content/feb2006/pi20060208_072238.htm.

[34] The APA was enacted as Public Law 79-404, 60 Stat. 237, codified at 5 U.S.C. 551-59, 701-6 and other scattered sections of 5 U.S.C.

[35] See 17 C.F.R. 201.192 (2004).

[36] Estimate by the Congressional Budget Office. The Federal Reserve remits its profits to the U.S. Treasury. Reported on the website of the Republican Study Committee, April 1, 2003; at johnshadegg.house.gov/rsc/LB4103.pdf.

[37] As one recent example, the trip from New York City to Raleigh-Durham NC, a

distance of 513 miles, would cost $460 (at 45¢ per car mile) plus tolls of about $30, a total of $490 round trip. The airfare was quoted as $252.

[38] See, for example, Cass R. Sunstein, “Cost-Benefit Analysis and the Separation of Powers,” 23 Arizona Law Review 1267 (1981), which notes that many laws have values other than the maximization of the cost-benefit result; Richard W. Parker, “Grading the Government,” 70 University of Chicago Law Review 1345 (2003), which reviews regulatory scorecards, a subcategory of CBA, concluding that the process is essentially worthless; and Regulation, a journal published by the American Enterprise Institute that periodically criticizes the CBA component of regulation. These criticisms have been voiced literally for decades; see, e.g., James S. Sagner, “Benefit/Cost Analysis: Efficiency-Equity Issues in Transportation,” 16 Logistics and Transportation Review 339 (1980), evaluating the CBA developed for the Bay Area Rapid Transit System (San Francisco) and for the Tennessee-Tombigbee Waterway and Locks and Dam No. 26 and concluding that the ex ante findings bore little resemblance to actual experience.

[39] This particular example is from John F. Morrall III (then an OMB economist), A Review of the Record, Regulation 25, 30, table 4 (1986).

[40] For an excellent set of comments on improving the process, see Parker, reference in note 38, at 1414-20.

[41] The reference is to the Biblical quote: “It is easier for a camel to go through the eye of a needle than for a rich man to enter into the kingdom of God.” Matthew 19:24.

[42] This recommendation is similar to the one suggested in Cass R. Sunstein, “Congress, Constitutional Moments, and the Cost-Benefit State,” 48 Stanford Law Review 247, 292-95 (1996).

CHAPTER 10: GLOBALIZATION AND BUSINESS REGULATION

We have met the enemy, and he is us.[1]
Walt Kelley (1913–1973)

When the first business regulation was enacted, America was fighting its Civil War and President Lincoln needed to stabilize banking and the issuance of currency. The enormous industrial boom that followed that war led to the economic development of the nation and changed the country from agrarian to industrial, from village to urban, from small merchant to giant corporation, and by the end of World War I, from a developing political state to a world power. Congress was alarmed by the growth of the trusts and the resulting injury to competition, and by populism and the potential for significant political change. As a result, restrictions on big business began to be enacted toward the end of the nineteenth century.

At the time of the passage of the Sherman Act, imports of goods to the U.S. were not significant enough for Congress to consider them as a source of competition for businesses that were attempting to restrain trade or monopolize. The nation was just beginning to industrialize, and given the time to cross the oceans, commerce was conducted largely between domestic companies. During the ensuing 115+ years, imports (excluding petroleum) have increased at three times the growth rate of American manufacturing.[2] The competitive situation in the twenty-first century is global and largely technology and e-commerce oriented,[3] and America is scrambling to compete with economies whose labor costs are as little as one-tenth of ours.

WHY THE URGENCY?

Business regulation has been in existence for more than a century, so some skeptics may wonder at the need for action now. After all, it was haste that led to many of these laws in the first place, and thoughtful deliberation would seem to be the proper approach. Past economic cycles followed relatively leisurely paths, and economies required centuries or generations to industrialize and grow. For example, we can count the modern development of the U.S. as requiring more than half a century, from about 1865 to about 1920. Similarly, the rise and fall of the Soviet Union required three-fourths of a century, from the Russian Revolution of 1917 to the collapse of Communism in 1991.

GLOBAL ECONOMIC INITIATIVES

In contrast, the present economic cycle has seen the ascendancy of centrally planned economies into global free market participants in about fifteen years, with the very real prospect of their shared leadership with the U.S. and possibly the European Union by the middle of the twenty-first century. The two fastest-growing countries are China and India, but others, including Brazil and Russia, may experience equivalent development. Japan and other Southeast Asian economies could be starting a recovery which could also push them into leadership contention; see Figure 10-1. World governments cannot afford to wait around for something to happen, because the imbalances that exist between the undeveloped, the developing, and the developed countries will inevitably become more pronounced. The result could be a political or economic catastrophe, perhaps triggered by the collapse of a currency, or a major bank failure, or the sudden decline in a financial market.[4]

Figure 10-1:
Selected Economic Growth Rates
(Based on Estimates of Real Gross Domestic Product)*

Region/Country	% of Growth (2005)
European Union	1.7
Developed Countries	
France	1.6
Germany	0.9
Great Britain (United Kingdom)	1.7
Japan	2.4
U.S.	3.5
Developing Countries	
Bahamas	3.5
Brazil	2.4
China	9.3
Czech Republic	6.0
Egypt	4.9
Hungary	4.1
India	7.6
Indonesia	5.4
Pakistan	6.9
Russia	5.9
Venezuela	9.3

In constant dollars, eliminating inflation.

Sources: Central Intelligence Agency, The World Factbook, 2006, at www.cia.gov/cia/publications/factbook; Economic Outlook No. 78, 2005, at www.oecd.org/dataoecd/41/33/35755962.pdf.

Some measures have been taken to deal with the new global realities, including the North American Free Trade Agreement (NAFTA); attempts at expansion of NAFTA, including the Central American Free Trade Agreement (CAFTA) and various bilateral trade agreements;[5] the European Union (EU); periodic meetings of the Group of Eight (G-8) finance ministers; industry-specific global agreements and the World Trade Organization (WTO); and other initiatives. No particular political party or lobbying effort is driving these actions, and most Western politicians can (and do) claim some measure of credit.

THE COMPETITIVE POSITION OF THE U.S.

America's dominant position that existed for decades is being challenged by the European Union, by the Association of Southeast Asian Nations (ASEAN), and by advances in countries throughout the globe.[6] Only 35 of the top 100 in the global 100 companies are now based in America, with another 49 located in Europe, 11 in Asia, and the others in various countries around the globe.[7] A more interesting statistic is the rise of companies outside the fortresses of strong business regulation – the U.S. and Europe – clearly indicating the potential for future global ascendance.

The Current Account is the net of a country's imports and exports and is used in calculating a country's Balance of Payments.[8] The U.S. is running a Current Account deficit of $700 billion,[9] the federal budget deficit exceeds one-half of a trillion dollars, and the dollar has been falling against the world's other major currencies. Every proposal that has a chance of dealing with the economic situation gets beaten down by one or another lobbying group: healthcare changes, Social Security, tax reform, movement on balancing the federal budget, energy conservation – the list goes on and on. Our growing struggle to compete has elicited no initiatives from a government with few

policy ideas except to ask the Chinese to stop manipulating their currency. Instead, efforts have been focused on tax relief for investors to keep them buying stocks and repeal of the alternative minimum tax (AMT).

LIMITATIONS TO ECONOMIC POLICY

Economic policy is, of course, a dual effort, between the fiscal decisions made on spending and taxes by Congress and the President and monetary decisions on interest rates and the money supply made by our central bank, the Federal Reserve (the Fed). The Fed has attempted throughout the past decade or so to steer its policies toward managing inflation while keeping the economy in a growth mode, and its performance has been commendable. However, the global economy and not U.S. demand is now driving the prices for commodities, and the Fed has neither the policy tools nor the models and data to help business to grow at a healthy and orderly pace.[10]

There is an ongoing debate as to whether the U.S. can compete with this enormous new motivated and educated workforce in Asia, in Eastern Europe, and in the developing areas of the Americas. U.S. jobs have been increasing in sectors that are somewhat difficult to export, including services and construction, while the stagnation in manufacturing is an old story.[11] Some service jobs have been outsourced to other countries, and most of us have had the experience of speaking with a representative of a computer or a credit card company in Ireland or India.

However, only about one-tenth of all service jobs could be performed outside the U.S.,[12] and few construction jobs could ever be exported. Furthermore, recent evidence indicates that the U.S. economy is increasing employment at a rate equivalent to that experienced by American companies in international locations.[13]

GROWING ECONOMIES AS COMPETITORS

The number of growing-economy companies is still relatively small; the companies in Figure 10-2 represent well less than half of the number in the U.S. and fewer than are in Japan. However, the smaller companies – those in the second half of the Forbes list – are nearly 60 percent of the total for the developing countries, a significantly greater proportion than in the U.S.[14] The potential for growth and intense future competition is obvious, particularly as many of the developing countries have only recently become capitalistic and are not limited by the niceties of much of American-style restraints on commerce.

Figure 10-2:
Number of Global 2000 Companies in Growing Economies

	Number of Global 200 Companies in Country	Number of "Smaller" Global 200 Companies*	% of "Smaller" Global 200 Companies
China	64	36	56.3%
South Korea	51	29	56.9%
Taiwan	41	24	58.5%
India	33	26	78.8%
Brazil	19	9	47.4%
South Africa	18	11	61.1%
Mexico	17	8	47.1%
Malaysia	14	9	64.3%
Russia	14	4	28.6%
Turkey	14	8	57.1%
Thailand	13	10	76.9%
Chile	6	5	83.3%
Indonesia	6	5	83.3%

Note: "Smaller" companies are those in the second half of the Forbes list.

Source: Derived from data in Forbes Global 2000, 2006 edition, issue of April 17, 2006, as supplemented from website data at www.forbes.com.

CHINA AND INDIA

China and India are special situations primarily because of their size, with a combined population of some 2.5 billion people, or more than one-third of the population of the world. Other significant differences include their demand for economic development, their readiness to cast aside previous political and economic beliefs, their access to vast amounts of resources, and their willingness to work with Western companies through joint ventures and other forms of business organization. Smaller countries like Japan and South Korea have had periods of unusual prosperity, but in the modern history of the world, only the U.S. is equivalent in size, access to resources, and growth. The case of Japan is particularly interesting, as America and the rest of the world actually felt economically threatened by Japanese competitors until the1990s, when a fifteen-year-long recession began.[15]

China has oriented its economy to manufacturing, while India uses its educational system to provide technological expertise, particularly in medicine and science, and in computers, software, and engineering. A synergy is beginning to develop between the two countries, with collaborations on orders from multinational companies to blend the technology of India with the advanced manufacturing of China in such products as medical devices, computer systems, and advanced mechanical devices.[16] This growth will be supported by an emphasis on intellectual development, particularly when compared to the mediocre results in the U.S., which is producing about one-tenth the number of engineers and scientists each year.[17] However, there are enormous obstacles to overcome as China and India develop economically, including rural poverty, inadequate infrastructure, and bureaucratic and inflexible governmental structures.

OTHER DEVELOPING ECONOMIES

The economic development in China and India has had extensive media exposure, and estimates are that over three-fourths of all new research and development centers will locate there in the next few years.[18] Other developing economies may begin to enjoy some of this economic growth; see Figure 10-2 to see countries often prominently mentioned. Smaller countries that are now represented on the list of the Global 2000 may surprise some readers; as examples, see the names in Figure 10-3. In contrast, the developed economies are growing at a significantly slower rate, with the U.S. able to sustain its economic activity through the world's willingness to finance chronic budget and balance of payments deficits.

Figure 10-3:
Smaller Developing Countries
with Global 2000 Companies

Bahamas	Teekay Shipping
Czech Republic	Cez Utilities
Egypt	Orascom Telecom
Egypt	Alexandria Natl Iron & St
Egypt	Orascom Construction Inds
Hungary	MOL Oil & Gas
Hungary	OTP Bank
Pakistan	Oil & Gas Development
Pakistan	Pakistan Telecom
Venezuela	Mercantil Financial Services

Source: See Table 10-2.

A quieter but ongoing parallel development has been the explosion in skill levels in other countries that are direct competitors with the established companies in the West. For example, Mexico has been encouraging "hard science" students for the past decade and currently enrolls 450,000 undergraduates in engineering (versus about 370,000 in the U.S.).[19] As a result, American companies are shifting production to offshore technological centers, where an experienced engineer earns about $30,000, well less than his or her American counterpart. Similarly, Argentina has become a growing center for software development, with companies attracted by low salaries, a well-educated labor force, and tax breaks for companies choosing relocation.[20]

COMPETITION OR COLLABORATION?

American companies are using developing countries for technical skills but not to collaborate with existing manufacturing, engineering, marketing, and computing facilities, at least to the current time.[21] While there is some talk about the potential for cross-border cooperation,[22] actual experience shows fairly low levels of integration and communication. Companies seem to go to developing countries for two reasons: to hire talented (and less costly) professionals and to begin to compete in local markets. The organizational skills required for collaboration simply do not exist in many companies; the process to develop such skills and confidence in the outcomes has not yet occurred.

The level of trust and understanding necessary for this type of collaboration to occur may require decades of effort. The world is not really flat (in Thomas Friedman's now famous phase); it is more concave, and we continue to rely on established cultural institutions, habits, roles, and traditions to organize ourselves.[23] While people eventually accept and use each other's ideas and rituals, this process takes considerable time along with a willingness to abandon old prejudices and preconceptions. America may be the great melting pot, but every other developing group of peoples on the globe is not yet ready to be mixed into the stew.

Furthermore, company cultures drive or deemphasize organizational collaboration. Disney is a classic examples of the former – a culture that requires employees to suppress their individuality and accept roles representing the company's persona; various high technology companies and Microsoft in particular could be cited as examples of the latter – cultures that thrive on the intellectual talents of the individual. These organizations reside within a single corporate shell and are dominated by the American experience. Offshoring cannot lead to instant business cultures, and it may require years to integrate workers in developing countries with those in a developed country. In sum, employment and economic projections tend to be somewhat alarmist.[24] We simply do not know how this new global marketplace will ultimately sort things out.

IS THERE TIME FOR THE U.S. TO RESPOND?

As a result of this enormous change in the global economy, the total world labor force has doubled since about 1990. Many of these workers are

un- or semieducated, with low expectations other than sufficient income to pay for the necessities of life. Workweeks can be fifty or sixty hours, fringe benefits are often minimal, and a long life expectancy or the idea of retirement (except as supported by one's own family) is unknown. The desire for education and upward mobility will vary across the growing economies, but we already see the results of the superior educational system of India, where the country's literacy rate is nearly 60 percent[25] as "hard science" professionals are entering the workforce by the millions.[26]

The hand-wringing responses to the present situation run the gamut from educational initiatives to laws to force companies to remain in America.[27] While the skill levels among American high school graduates are clearly deteriorating,[28] how can we motivate students to study if they would rather play video games? School system budgets are already stretched, and why would throwing more money at the problem necessarily solve anything?[29] Requiring that students pass standardized tests only leads schools to "teach to the test" and not to any real learning.[30] As to passing legislation requiring companies to remain in the U.S., no one has been able to construct a law that is both constitutional and not an invitation to relocate to friendlier sites outside the country.

AMERICA'S STRENGTHS

The U.S. leads the world in the design, implementation, and integration of successful business strategies. Of the largest 2,000 public companies, 693 are located in the U.S.,[31] as are 13 of the top 25; for a listing of the latter group, see Figure 10-4. American companies continue to develop marketing concepts that astonish the world's consumers, including techniques of distribution, retailing, advertising, and promotion that are beyond leading edge. To cite one example of hundreds, Wal-Mart has revolutionized retailing in America, but it is Mexico that has most recently experienced its innovations in huge store size, low prices, inventory management, and customer service. In 2004, Wal-Mart did about $12.5 billion in sales in Mexico, competing with and beating small, inefficient local retail outlets, and their expectation is to continue to grow these international investments.[32]

Figure 10-4:
Global Top 25 Companies
(all $ in billions)

Rank	Name	Country	Industry	Sales	Profits	Assets	Market Value
1	Citigroup	U.S.	Banking	$120.32	$24.64	$1,494.04	$230.93
2	General Electric	U.S.	Conglom-erates	149.7	16.35	673.3	348.45
3	Bank of America	U.S.	Banking	85.39	16.47	1,291.80	184.17
4	American Intl Group	U.S.	Insurance	106.98	11.9	843.4	172.24
5	HSBC Group	United Kingdom	Banking	76.38	12.36	1,274.22	193.32
6	ExxonMobil	U.S.	Oil & gas operations	328.21	36.13	208.34	362.53
7	Royal Dutch/Shell Group	Netherlands	Oil & gas operations	306.73	25.31	216.95	203.52
8	BP	United Kingdom	Oil & gas operations	249.47	22.63	206.91	225.93

Rank	Name	Country	Industry	Sales	Profits	Assets	Market Value
9	JPMorgan Chase	U.S.	Banking	79.9	8.48	1,198.94	144.13
10	UBS	Switzerland	Diversified financials	78.25	10.65	1,519.40	105.69
11	ING Group	Netherlands	Diversified financials	137.11	8.52	1,369.55	81.43
12	Toyota Motor	Japan	Consumer durables	173.09	10.93	227.05	175.54
13	Wal-Mart Stores	U.S.	Retailing	312.43	11.23	138.17	188.86
14	Royal Bank of Scotland	United Kingdom	Banking	55.05	8.66	1,119.90	106.41
15	Total	France	Oil & gas operations	144.94	14.51	125.47	154.74
16	Chevron	U.S.	Oil & gas operations	184.92	14.1	124.81	126.8
17	BNP Paribas	France	Banking	60.9	6.33	1,227.95	77.73
18	Berkshire Hathaway	U.S.	Diversified financials	76.33	6.74	196.71	133.67
19	Banco Santander	Spain	Banking	44.81E	8.54	956.39	91.34
20	Barclays	United Kingdom	Banking	47.87	5.92	1,587.06	75.99

Rank	Name	Country	Industry	Sales	Profits	Assets	Market Value
21	Procter & Gamble	U.S.	Household & personal products	61.68	7.79	136.52	197.12
22	Conoco Phillips	U.S.	Oil & gas operations	162.41	13.62	107	83.99
23	IBM	U.S.	Technology hardware & equipment	91.13	7.97	105.75	126.74
24	HBOS	United Kingdom	Banking	51.74	5.87	850.06	71.25
25	Verizon Commun-ications	U.S.	Telecommunications services	75.11	7.4	168.13	93.18

Note: Ranks are based on a composite score for sales, profits, assets, and market value.
Source: See Figure 10-2.

Besides marketing expertise, U.S. companies and the business environment possess numerous advantages that support the nation's competitive position:

- The continued development of breakthrough technologies and logistical information, communications, and biotechnology. Dell is a leading example of a company that acquires technology developed by others but produces a consumer product using excellent supply chain management techniques.
- The creation of innovative solutions to the globe's expanding

requirements for financial capital. America's stock and bond exchanges have long provided capital for domestic and foreign companies and governments.

- A university infrastructure that supports world-class research. The U.S. continues to lead the world in excellence in higher education regardless of the criterion used: Nobel prize winners,[33] numbers of PhDs awarded,[34] applications for enrollment in American colleges by secondary school graduates from other countries,[35] or most other educational statistics.
- A democratic form of republican government that permits dissent without overwhelming the political and economic structures of the nation. The right to petition and influence lawmakers and members of the executive branch is unparalleled in the world, and while there are certainly excesses, the system works both for business and for individuals.
- A willingness to accept risk and to design tools to manage that risk. Risk management has become a major concern of U.S. business, and techniques have been created to measure and hedge just about every type of risk imaginable.[36]
- The acceptance that challengers within an industry inevitably push their larger competitors to innovate or creatively destruct.[37] IBM is a leading example of a company that was forced to change its business strategy in order to survive; in demanding changes to IBM's business model, Chairman Louis Gerstner may have been looking over his shoulder at the wreckage of computer companies like Wang, previously an industry leader in word processing but now in the

business graveyard.

These accomplishments occur within regulatory structures that constrain the functioning of the free marketplace. Situations noted throughout this book include restrictions on merger and acquisition strategies due to antitrust concerns; overemphasis on financial controls and other restrictions due to corporate governance concerns; and an inadequate focus on structural risk within the financial services industries. Business regulation removes the opportunity for open competition against foreign companies that are restricted only by the rigors of the marketplace.

WHERE SHOULD WE FOCUS OUR EFFORTS?

The American consumer faces uncertainty and inadequate protection when encountering goods from U.S. sources or other countries that may prove to be harmful or even lethal. The recent situation of toys from China is the most recent of numerous product recalls, and some manufacturers and consumer groups are now asking for new federal mandates to protect health, safety and the environment.

In addition to toys, a listing of businesses facing litigation, economic loss and public outrage includes food products, where two dozen E. coli outbreaks have occurred in a decade; the mortgage industry, with the well-publicized sub-prime credit problems; pharmaceuticals, facing patient lawsuits supposedly made ill from insufficiently tested drugs; and environmental polluters, particularly carbon dioxide emissions that appear to be driving global warming.[38] Federal standards could mitigate the deluge of consumer lawsuits, while increased review and enforcement by the various administrative agencies could prevent future incidents.

THE REPEAL OF BUSINESS REGULATIONS

If business regulations were repealed, what would be the result? It is impossible to predict the behavior of U.S. corporations in the face of global competition, outsourcing, the ongoing struggle for efficiencies, and a stock market that examines every corporate announcement or earnings miss with a skeptical eye. We cannot look for precedents to the period before regulation began to be used in specific situations (like banking and antitrust), because the U.S. was relatively isolated from global markets and the Industrial Age was just beginning. Nor can we jump forward to the early Depression years, when regulation became the accepted “disciplinarian” of U.S. markets, because the government was attempting to manage a crisis that had no parallel in modern economic history.

In more recent days, would Enron have occurred if there had been a Sarbanes-Oxley Act? We cannot peer into the minds of CEO Kenneth Lay or CFO Jeffrey Skilling, but we do know from testimony in the 2006 criminal trial that neither man believed he did anything wrong.[39] If existing laws did not prevent their crimes, how would Sarbanes-Oxley change anything? Alarmists will likely respond to the idea of ending business regulation by screaming about monopoly, the lessons of the recent fraud cases, evil bankers and other financial professionals, and airplane disasters. In much the same way, Margaret Thatcher (the former British prime minister) faced substantial opposition to her scheme of privatization, which, of course, was ultimately extremely successful.[40] Peaceful outcomes will probably occur; specific situations are noted in the sections that follow.

ANTITRUST

Possibly the closest parallel to the changes proposed in this book to antitrust is Europe of the pre–EU period. Even though cartels existed to restrict competition during parts of the twentieth century, there is no evidence of serious injury to competition or of the types of behaviors of American trusts that led to the passage of the Sherman Act.[41] Of course, throughout much of this period, Europe was fighting or attempting to recover from two world wars, so the European analogy is somewhat strained. And current domination by the strong antitrust position of the EU makes present-day comparisons unrealistic.

Japan has had some form of cartel behavior going back to the nineteenth century (through zaibatsu and their successor keiretsu organizations) with mixed outcomes. Positive results were certainly experienced from the end of World War II to about 1990, but a recession ensued driven largely by poor investment judgment in developing Asian economies and inappropriate lending decisions within keiretsu groups.[42] The U.S. generally prohibits industrial companies from engaging in banking activities, so a repetition of the Japanese experience is very unlikely.[43] On balance, it is difficult to argue that our economic system would not proceed in a civil and orderly fashion in the face of global competition.

BANKING

The American banking system has endured numerous shocks and financial losses through the support and oversight of the Federal Reserve System and the Comptroller of the Currency. So long as safeguards continue for depositors and the banking system, there are likely to be few adverse reactions to the removal of the restrictions noted in this book, including bank tying arrangements, interest on corporate demand deposit accounts, and

bank mergers. Banking continues to experience healthy competition from both U.S. and global financial institutions. There are now over 200 financial services organizations (including 127 commercial banks) located throughout the globe with assets of more than $50 billion; Figure 10-5 summarizes these institutions.

Figure 10-5:
Global Financial Institutions
(with assets greater than $50 billion)

	Assets in trillions (T) or billions (B)				
Region	**Greater than $1 T**	**$500 B - $1 T**	**$250 B - $500 B**	**$100 B - $250 B**	**$50 B - $100 B**
U.S.	3	7	7	16	17
Other North American	0	0	4	3	4
European	10	9	16	21	21
Asian	2	1	3	11	30
Australian	0	0	1	3	3
Other*	0	0	0	3	6
Totals	15	17	31	57	81
Grand Total	201				
*India				1	
South Africa				1	1
Brazil				1	2
Russia					1
Israel					2

Source: See Table 10-2.

Any of this group of foreign banks has adequate size and resources to compete with U.S. banks for corporate customers. Foreign banking institutions play an important role in the U.S. financial system; in 2005, foreign banking institutions held over $1.85 trillion in assets, nearly 20 percent of the total commercial banking assets in the U.S..[44] The American regulatory environment is very similar for U.S. and foreign banks, and so long as the government's regulations are followed regarding foreign bank activity in the U.S.,[45] there is little likelihood of denial of funds to creditworthy corporate borrowers or unfair practices in providing services.

FINANCIAL SERVICES

The financial services industry faces continuing competition from within the U.S. and from global institutions, including seventy-five global securities and insurance companies with more than $50 billion in assets; see Figure 10-4.[46] There is a clear need for regulation to protect investors, policyholders, governments, and other constituencies, but the laws continue to reflect an industry profile from the 1930s rather than that of three-fourths of a century later. Changing the form of regulatory coverage would strengthen the competitive environment while reducing the risk of a significant failure. As noted in Part I, institutions should be protected through the management of insurance, business, and systemic risk, while individuals continue to be protected against unfair practices.

The British and Japanese experiences were reviewed previously, and we noted that those countries have attempted to modernize their regulation of financial services through a consolidation of responsibilities. The British approach seems to be more effective than that of Japan, and certainly both the UK and Japan approach the reality of financial services company integration

with greater logic than the U.S.. The worry is that there is no comprehensive approach to the management of the various risks inevitably encountered by banks, securities firms, and insurance companies. This refusal by Congress to accept responsibility to protect individual and institutional investors and the integrity of the markets may lead to a worse result than if deregulation (in the Gramm-Leach-Bliley Act) had never occurred.

THE AIRLINE INDUSTRY

The issue for the U.S. airline industry is continued existence, not restrictive regulation (except for safety and security). Other than the survivors, no one is made better off when airlines fail: not employees and their families, not passengers, not rural areas that may see a loss of service, not airports and ancillary service organizations that lose revenue, and certainly not stockholders and lenders. Mismanagement by the airline companies and by incompetent regulators is responsible for the situation. It is inconceivable that ending the types of regulations discussed in this book would worsen the current situation, and a strong argument can be made that quickly moving to oligopoly would strengthen the companies by enladging markets and providing some$pricing power.

The international concept of national flagship airlines subsidized by countrigs has given way to competition, largely because of the realities of the global marketplace.[47] EU countries have fostered airline"competition through privatization, the relaxation of rules governing ownership and control by that nation's citizens or the govárnment, and the construction of$alternative airports for domestic and international flights (e.g., Gatwick in the London area). There are now about two dozen global airlines with adequate size and potential profitability to cope with the difficult conditiíns facing the industry; see Fig÷re 10-6. However, the realities of low profitability and deregulation will likely lead to contiþuing consolidation of the indusäry, with the likelihood of about half of that number surviving to compete in global markets.[48]

Figure 10-6: Global Airlines (All $ in billions)

Name	Country	Sales	Profits
Air France-KLM Group	France	$24.71	$0.45
Deutsche Lufthansa	Germany	23.02	0.55
AMR	U.S.	20.71	-0.86
Japan Airlines	Japan	19.87	0.28
UAL	U.S.	17.38	-21.18
Delta Air Lines	U.S.	15.69	-4.79
British Airways	United Kingdom	14.77	0.47
Northwest Airlines	U.S.	12.12	-1.58
All Nippon Airways	Japan	12.06	0.25
Continental Airlines	U.S.	11.21	-0.07
Qantas Airways	Australia	9.63	0.58
SAS Group	Sweden	7.78	0.02
Southwest Airlines	U.S.	7.58	0.55
Singapore Airlines	Singapore	7.28	0.84
Korean Air	South Korea	7.16	0.48
Iberia	Spain	6.24	0.30
Alitalia Group	Italy	5.52	-1.10
US Airways Group	U.S.	5.08	-0.34
Cathay Pacific Airways	Hong Kong/China	5.03	0.57
Thai Airways Intl	Thailand	3.96	0.17
Air China	China	3.72	0.29
Ryanair Holdings	Ireland	1.73	0.35

Note: Includes carriers whose primary emphasis is passenger traffic.

Source: See Table 10-2.

CORPORATE GOVERNANCE

The acts of a few corporate executives have changed the priorities and desponsibilities of the managers0of all publicly traded U.S. companies. As described in Chapters 6 and 9, no economic analysis was ever conducted to determine¢if the potential benefits were worth the costs, nor was there any compelling evidence developed$to show that corporate fraud woóld be prevented by the enactment of the Sarbanes-Oxley Act. Because the law is of such recent véntage, one cannot claim that thçre would be a negligible impact from its repeal. What is clear is that the costs to U.S. business are very extensive, likely recching into the tens of billions of dollars when implicit costs are included, in addition to resäricting the freedom of action or American managers. In addition, global companies are reconsidering decisions to list their shaäes on U.S. stock exchanges.

Ecrope to this time has not approached the problem through an EU solution, largely bacause corporate law has not been harmonized among the twenty-five member nations. Instead, various country governance codes åontinue to exist, making it difäicult for multinational countries to respond to each country's requirements. Instead, the High Level Group created to develop a&comprehensive EU policy determined that marketplace and institutional reforms should drive any ãolutions.[49] Japan's approach has been to allow companies to choose between a Western-type board of directors or committee strucrure and a statutory auditor stracture, with an audit board equivalent to the board of directors empowered to monitor legal comp~iance and financial reporting.[50]

WHAT THE U.S. MUST DO

Every preceding chapter in this book ended with a seõtion on "what the U.S. should do." This concluding section is more in the form of a demand – we must deal with"a global economy that is indiffqrent to (and probably cheers) restrictive regulations on U.S. businesses. Our competitors realiüe that markets do not tolerate mnefficiency or position based on past success. The appropriate role of government is to become uupportive and not restrictive oä business. In situations where there are no or few barriers to action, companies and institutioxs will continue to seek opportuüities to make superior returns. There are scores of examples that could be referenced; a very tymely one is the situation in thó global financial markets.

The expansion of the NYSE into the European stock markets (noted in¢Chapter 7) was ostensibly initicted in 2006 in the effort to provide access to global sources of capital for companies and inveõtment opportunities for instituâional and individual investors.[51] A darker reading of the merger is that the U.×. is no longer where large compánies come to raise funds; in testimony before the SEC, a NYSE executive revealed that twenty¿three of twenty-four corporabions recently seeking in excess of a billion dollars in capital chose to raise capital on foreiçn exchanges.[52]

The NYSE and NASDAQ strategies have been driven by the restrictions placed on all corporations listing in the U.S. by the Sarbanes-Oxley Act, as the American exchanges seek ways to continue to do business with companies not wishing to meet this Act's requirements.[53] Fortunately, regulations do not restrict the expansion of the NYSE (and other American exchanges like the NASDAQ) into other countries, and U.S. regulators can only look on in envy (or relief).

There is an important lesson here – the future lies in the global marketplace and American business must not be artificially limited in seeking

opportunities for economic growth. Treasury Secretary Henry Paulson, Jr., recognizes this situation and convened a national conference on regulation to question whether the right balance had been struck "between investor protection and market competitiveness." He may have read an advance copy of Chapter 9 in this book, for an important observation was that the costs of many regulations have been inadequately considered.[54] While it is useful to convene meetings and begin discussions, there is only a limited amount of time before global forces will have overwhelmed America's ability to compete.

Clearly there is no simple answer to improving American competitiveness and to assure the nation's leadership role in global markets. In the words of the senior economist of Business Week, Michael Mandel:
"Global forces have taken control of the economy. And government, regardless of party, will have less influence than ever."[55]

We must continue to exploit America's advantages in marketing, technology, finance, risk management, and the entrepreneurial spirit of creative destruction. In addition, we must end the regulation of U.S. business except as it applies to the protection of the individual or the natural world. In the words of Pogo (which opened this chapter): "We have met the enemy, and he is us."

ENDNOTES FOR CHAPTER 10

(Endnotes)

[1] From the Pogo comic strip. This is a twist on the quote "We have met the enemy, and they are ours," from a dispatch from U.S. brig Niagara to General William Henry Harrison, announcing his victory at the battle of Lake Erie, September 10, 1813.

[2] Derived from data in Historical Statistics of the U.S. (1989), series P1-12, U1-25; and from current U.S. Department of Commerce data on Table 2: U.S. Trade in Goods, at www.bea.gov/bea/ international/ bp_web/simple. cfm?anon=71&table_id=2&area_id=3.

[3] See James Sagner, Financial and Process Metrics for the New Economy (2001), particularly Chapter 3.

[4] See, e.g., the comments of the Chief Economist of Business Week, Michael Mandel, in "Bubble, Bubble, Who's in Trouble?" June 26, 2006 34-36: "Which bubble or bubbles are going to pop … Will the U.S. be hit the hardest, or China, or commodity markets?... will the ensuing economic collapse be limited to the U.S. or spread worldwide?" Mandel goes on to mention various areas for concern, focusing particularly on hedge funds.

[5] The Central America Free Trade Agreement (CAFTA) is a free trade agreement that now includes the U.S., Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic. It was ratified by Congress in 2005. Bilateral free trade agreements have been negotiated with several countries; for a current listing, see www.ustr.gov/Trade_Agreements/Bilateral/Section_Index.html.

[6] For an explanation of these organizations, see any text on global business; e.g.,

John D. Daniels, Lee H. Radebaugh, and Daniel P. Sullivan, International Business: Environment and Operations (2007, 11th edition).

[7] Derived from data in "Forbes 2000: The World's Biggest Public Companies," Forbes, April 17, 2006, 103-203.

[8] Surpluses or deficits are largely offset by the capital account, which is the net of investments or funds movements among countries.

[9] In 2005, U.S. exports were $1.27 trillion and imports were $2.00 trillion. The difference was largely compensated for by a capital account surplus of $0.49 trillion. For statistics, see www.bea.gov/bea/newsrel/transnewsrelease.htm.

[10] See, e.g., Catherine Yang, "A Narrow Window on the World," Business Week, June 5, 2006, 91.

[11] There has been essentially no growth in the manufacturing sector since the 1950s. In 1956 there were 15.8 million manufacturing jobs, representing one-third of all nonfarm private employment. In 2006, there were 14.2 million such jobs, only one-eighth of all nonfarm private employment. Statistics are derived from the U.S. Department of Labor, Bureau of Labor Statistics website, at ftp.bls.gov/pub.

[12] Diana Farrell, "Don't Be Afraid of Offshoring" (report of the McKinsey Global Institute), BusinessWeek Online, March 22, 2006, at www.businessweek.com/ globalbiz/content/mar2006/gb20060322_649013.htm.

[13] Laura D'Andrea Tyson, "An Economic Tsunami," The American Prospect On-Line, October 5, 2005, reviewing Clyde Prestowitz, Three Billion New Capitalists (2005) and Martin Wolf, Globalization: Why It Works (2004), at www.prospect. org/web/page.ww?section=root&name=ViewPrint&articleId=10308.

[14] Data are derived from tables in the Global 2000, reference in note 7, as supplemented from website data at www.forbes.com. There are 310 smaller companies in the developing countries in Figure 10-1, or 59.4 percent. The U.S. has 693 companies on the list; 48.9 percent are smaller companies. Japan has 320 companies on the list; 56.3 percent are smaller companies.

[15] See, e.g., Daniel Burstein, Yen!: Japan's New Financial Empire and Its Threat to America (1990). Although many Westerners were concerned about the Japanese ascendancy, a prescient book by Bill Emmott, The Sun Also Sets: The Limits to Japan's Economic Power (1991), correctly forecast Japan's recent decline.

[16] An excellent survey on these developments can be found at "China & India," Business Week, August 22/29, 2005, 50-136.

[17] See the website of the McKinsey Global Institute for various statistics and forecasts, at www.mckinsey.com/mgi. This insight is from "The Emerging Global Labor Market: Part I – The Demand for Offshore Talent in Services" (June 2005), 6-10.

[18] See Pete Engardio, "R&D Offshoring: Is It Working?" Business Week, May 10, 2006, at www.businessweek.com/globalbiz/content/may2006/gb20060510_613772.htm?campaign_id=search.

[19] Statistics are from Geri Smith, "Look Who's Pumping Out Engineers," Business Week, May 22, 2006, 42-43, citing data from the National Association of Universities and Institutions of Higher Education (Mexico) and the American Society for Engineering Education.

[20] See "Can Latin America Challenge India?" Business Week, January 30, 2006, at

www.businessweek.com/magazine/content/06_05/b3969427.htm?campaign_id=search. The article also cites developments in Chile and Nicaragua.

[21] Engardio, reference in note 18.

[22] See, e.g, Thomas L. Friedman, The World Is Flat (expanded ed., 2006), Chapter 6.

[23] However, I am grateful for Friedman's ideas on this issue; ibid., Chapter 4.

[24] E.g., note the subtitle of Prestowitz's book, Three Billion New Capitalists (2005), reference in note 13: "The Great Shift of Wealth and Power to the East."

[25] Literacy is defined as the proportion of the population aged fifteen and over who can read and write. Recent statistics show this amount to be 59.5 percent, with males at 70.2 percent and females at 48.3 percent. In contrast, the U.S. literacy rate is 99 percent. Central Intelligence Agency, The World Factbook, 2006, at www.cia.gov/cia/publications/factbook.

[26] Some 3 million finance, accounting, engineering, and life science university graduates will enter the U.S. labor force in 2006, according to the McKinsey Global Institute. For comparison, China will produce about 4 million individuals with equivalent skills, while the U.S. will produce 3.25 million. However, there is an upward trend in the projections of Indian and Chinese graduates, while the U.S. will continue to decline in the life sciences. See "China & India," reference in note 16, page 57.

[27] See, e.g., Geoffrey Colvin, "Can America Compete: The 97-Pound Weakling," 152 Fortune Magazine 70 (July 25, 2005). An important book on the subject is Daniel Yergin and Joseph Stanislaw, The Commanding Heights: The Battle for the World

Economy (2002).

[28] The performance of U.S. fifteen-year-olds in 2003 as measured by the Program for International Student Assessment (PISA) in mathematics literacy and problem solving was lower than the average performance for most Organization for Economic Cooperation and Development (OECD) countries. The U.S. had a greater percentage of students below level 1 and at levels 1 and 2, and at levels 4, 5, and 6 than the OECD average percentages. Digest of Education Statistics, 2004, at www.ed.gov (Web site of the U.S. Department of Education).

[29] E.g., Richard Colvin of Columbia University's Teachers College discusses this point in Malcolm A. Kline, "More Money Not the Answer to School Woes, Ivy League Expert Says," Accuracy in Academia, November 2003, at www.academia.org/campus_reports/ 2003/cr_money_school.html.

[30] Public Law 107-110, the No Child Left Behind Act of 2001, 20 U.S.C. 6301 et seq. Teachers' unions such as the National Education Association and the American Federation of Teachers oppose these reforms, as do websites like www.nochildleft.com, and they have worked to weaken the law's provisions and to change public perception of the law and its necessity. For a perspective on how money does not necessarily solve the propblem, see Jay Greene and William C. Symonds, "Bill Gates Gets Schooled," Business Week, June 26, 2006, 65.

[31] Forbes 2000, reference in note 7.

[32] From "Mexico Operations," at walmartstores.com/GlobalWMStoresWeb/navigate.do? catg=379&contId=5385. As of May 2006, there were nearly 2,700 stores outside the U.S., concentrated primarily in the Americas and Western Europe.

[33] For a list of American Nobel prize winners see www.u-s-history.com/pages/h2007.html; for the complete listing, see nobelprize.org.

[34] The U.S. still easily leads in the number of PhDs awarded; see www.nber.org/~sewp/events/2005.10.19/BoundTurner_int_phd_1017.ppt#22.

[35] Global comparisons of higher educational levels are difficult to obtain; a leading source is the National Center for Education Services, at nces.ed.gov/surveys/international. According to the most recent data, the U.S. reports a significantly higher expenditure per student, at Figure 21; a higher percentage of the population enrolled for all age cohorts (except for the 25-29 group, where Germany leads), at Figure 21a; and far more foreign students enrolled, at Figure 23a. However, the most recent data are from 2001, and include only Canada, France, Germany, Italy, the United Kingdom, and the U.S..

[36] Companies can now hedge their exposure to hurricanes and other catastrophic weather systems through weather derivatives and other risk management techniques. A Google search on "weather risk management" in mid-2006 provided over 30,000 hits!

[37] "Creative destruction" was a concept of Harvard economist Joseph Schumpeter; see Capitalism, Socialism and Democracy, 1942, Chapter 7.

[38] For a review of this situation, see Eric Lipton and Gardiner Harris, "In Turnaround, Industries Seek U.S. Regulations," New York Times, September 16, 2007, A1, A13.

[39] The Enron case predated the Sarbanes-Oxley Act, and federal prosecutors instead brought other charges. Lay was convicted of all six conspiracy and fraud counts he faced, while Skilling was convicted on nineteen of twenty-eight counts of

conspiracy, fraud, and insider trading; U.S. v. Skilling, 04-cr-25, U.S. District Court, Southern District of Texas (Houston). For news accounts of the case, see various issues of the New York Times. For a recent analysis of the accounting issues, see Kurt Eichenwald, Conspiracy of Fools, 2006. For the verdict in the case, see "Lay, Skilling Are Convicted of Fraud," Wall Street Journal, May 26, 2006, A1, A9. The Wall Street Journal editorialized that "these convictions of individuals – some 30 in the Enron case alone – will do more to deter future corporate crime than anything in Sarbanes-Oxley." "The Enron Verdicts," May 26, 2006, A10.

[40] In 2006, there were still more than 50,000 Google hits on Ms. Thatcher + privatization + opposition!

[41] For a review of this period of European economic history, see Andreas Resch, Phases of Competition Policy in Europe, Institute of European Studies (University of California, Berkeley) paper 050401, 2005, at repositories.cdlib.org/ies/050401.

[42] For a useful history of the economic and cultural aspects of Japanese business policy, see Andrew Gordon, A Modern History of Japan: From Tokugawa Times to the Present, 2002.

[43] Federal banking law prohibits nonfinancial holding companies from owning a depository institution although industrial loan banks (ILBs) or industrial loan companies (ILCs) are allowed. For the specific regulation on this prohibition as originally in the Glass-Steagall Act and strengthened in the Gramm-Leach-Bliley Act, see FDIC, "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective," at www.fdic.gov/regulations/examinations/supervisory/insights/sisum04. For an explanation of ILBs/ILCs, see www.financialpolicy.org/fpfspr13.htm.

[44] Federal Reserve Board, "Share Data for U.S. Offices of Foreign Banks," Statistics: Releases and Historical Data, Table 1: Selected Domestic Assets and Liabilities of U.S. Offices of Foreign Banks, at www.federalreserve.gov/releases/iba/Share/SHRTBL1.html.

[45] The International Banking Act of 1978 (IBA) brought the rules governing the regulation of foreign banking organizations (FBOs) into close alignment with those pertaining to U.S. banks, particularly those relating to chartering, branching, and reserve requirements. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 included provisions granting foreign bank branches and agencies operating in the U.S. direct access to Federal Reserve services and privileges such as check clearing, provision of coin and currency, Fedwire, and the discount window. Another important provision of DIDMCA was to subject all foreign banking institutions accepting deposits to Federal Reserve requirements. There are some situations where foreign banks are exempt from some Federal Reserve regulations. (Rules regarding FBOs can be found in Federal Reserve System Regulation K: International Banking Operations.) See the website of the Federal Reserve Bank of New York for additional information: www.ny.frb.org/aboutthefed/fedpoint/fed26.html. Another excellent source is PricewaterhouseCoopers, Regulatory Guide for Foreign Banks in the U.S., 2005–2006 edition, available at www.pwcglobal.com/extweb/pwcpublications.nsf.

[46] Forbes 2000, reference in note 7.

[47] For a review of the European market, see Paul Stephen Dempsey, "Competition in the Air: European Union Regulation of Commercial Aviation," 66 Journal of Air Law and Commerce 979 (2001). For the Japanese and other global markets, see Daniel Yergin, Richard H. K. Vietor and Peter C. Evans, Fettered Flight: Globalization and the Airline Industry, 2000, at www.airlines.org/files/fetteredflight.pdf.

[48] Excluding UAL (parent of United Air Lines), which lost more than $21 billion, the global airline industry lost about $2.5 billion in the most recent reporting period. Derived from data in Forbes, reference in note 7.

[49] The High Level Group of Company Law Experts was established in 2001 to determine the regulatory framework for EU companies. See the High Level Group of Company Law Experts, Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2002), at europa.eu.int/comm/internal_ market/en/company/company/modern/ consult/report_en.pdf. These issues are reviewed in Elias Mossos, "Sarbanes-Oxley Goes to Europe: A Comparative Analysis of U.S. and European Union Corporate Reforms after Enron," 13 Currents: International Trade Law Journal 9 (2004).

[50] See Ronald J. Gilson and Curtis J. Milhaupt, "Choice as Regultory Reform: The Case of Japanese Corporate Governance," 53 American Journal of Comparative Law 343, 352-55 (2005).

[51] For a report of the NYSE's move to globalize, see Jenny Anderson and Heather Timmons, "NYSE Group Reaches Deal to Acquire Euronext," New York Times, June 2, 2006, C3. Euronext was created from mergers of the Paris, Amsterdam, and Brussels stock exchanges and Liffe, the London derivatives exchange.

[52] Reported by Helen Shaw, "Can SOX 404 Be Measured?" CFO.com, SEC/PCAOB hearing of May 10, 2006 (on Section 404 of the Sarbanes-Oxley Act), at www.cfo.com/article.cfm/6940147?f=home_featured.

[53] For a brief review of this development, see Jane Sasseen and Joseph Weber, "Taking Their Business Elsewhere," Business Week, May 22, 2006, 33-34.

[54] Stephen Labaton, "Paulson, at Talks on Regulation, Suggests Pendulum Has Swung Too Far," New York Times, March 14, 2007, C3.

[55] "Can Anyone Steer This Economy?" [cover story], Business Week, November 20, 2006, 56-62.

A NOTE ON SOURCES

Throughout this book, legal, business, and economic references are used to support information and statements appearing in the text. While endnoting systems tend to be fairly standard within each of these disciplines, some readers may not be familiar with certain bibliographical formats. Therefore, the approach used has been to provide as much information as possible for each citation, rather than to follow the abbreviated names often used in legal citations.

As one example, although the correct citation for Stanford University's law review is Stan.L. Rev., the full title, Stanford Law Review, is used to allow the reader to easily determine the source. The references consistently follow the legal citation format of placing the volume number before the journal name, the first page number of the article after the journal name, and the date of the issue in parentheses, as in 38 Stanford Law Review 1189 (1986).

Statutes are laws enacted by legislatures; all references in this book are to laws enacted by the U.S. Congress and are referred to as U.S. Statutes at Large (Stat.). The references to statutes follow the customary format, with the title of the law being cited, followed by the Public Law citation and the placement in the U.S. Code (U.S.C.). As an example, the presentation of the Foreign Corrupt Practices Act of 1977 is 91 Stat. 1494; Public Law 95-213 (the 213th law passed by the 95th Congress), 15 U.S.C. § § 78m, 78dd, 78ff, and inserted in various sections of Title 15 of the U.S.C. Regulations are written by executive agencies under authority of a statute. Proposed and recently adopted federal regulations are published in the Federal Register and compiled in subject order in the Code of Federal Regulations (CFR).

Court decisions are listed as volume number of the reporter, the short name of the reporter, and the first page and year of the decision. For example, the case of U.S. v. Aluminum Co. of Am., 148 F.2d 416 (1945) is reported in the

Federal Reporter, 2nd series, volume 148 (which includes some of the circuit court decisions decided in 1945), beginning at page 416. The abbreviations used in the law reporters for company names are retained throughout this book. A “U.S.” court decision refers to the Supreme Court; Fed. (and 2d and 3d) refer to circuit court decisions; and F.Supp. refers to district court decisions reported in the Federal Supplement series.

Many libraries provide access to LexusNexus, the source for most of the legal citations in this book. Any reader wishing to see specific U.S. Code sections, cases, or law review articles should use this database. In addition, a number of law school libraries and other legal sources are available on the Web; a Google search will likely turn up a number of free sites. The New York Times is used extensively in the book for reports of various news events. Although the New York Times has Website access to its articles, there is a fee for research. The interested reader should determine if her or his library provides free access to the New York Times through ProQuest or other databases.

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